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Federal Income Taxation of Scholarships and Fellowships: A Practical Analysis

Mary Ann Tucker*

I. Introduction

The general rule of federal income taxation always has been that all income is taxable unless excluded from gross income by a specific section of the Internal Revenue Code.[1] Prior to 1954, there were no provisions in the revenue laws pertaining directly to scholarships and fellowships. Grants given to enable the recipient to pursue study or research were subject to income taxation as compensation unless they were excluded from gross income as gifts.[2]

Lack of consideration was the crucial factor in determining whether an educational grant was a gift.[3] A grant made to an individual for the purpose of furthering his education, with no services being rendered to the grantor in exchange, was considered a gift and thus was excludable from gross income.[4] If, however, the recipient provided his personal skills, training, or experience, or any other consideration, the grant was regarded as compensation for services rendered.[5] The intent of the grantor

*Member of the Indiana Bar. B.S., North Dakota State University, 1961; M.S., Iowa State University, 1965; J.D., Indiana University, 1973.

[1]Int. Rev. Code of 1954, § 61; Int. Rev. Code of 1939, § 22(a).

[2]Int. Rev. Code of 1954, § 102, and Int. Rev. Code of 1939, § 22(b), govern the exclusion of gifts from gross income.

[3]Ephraim Banks, 17 T.C. 1386 (1952).

[4]This test was set out as follows:

> The amount of a grant or fellowship award is included in gross income unless it can be established that such amount is a gift. If a grant or fellowship award is made for the training and education of an individual, no services being rendered as consideration therefor, the amount is a gift which is excludable from gross income. However, when the recipient applies his skill and training to advanced research or some other activity the essential elements of a gift are missing and the amount is includable in gross income.

I.T. 4056, 1951-2 Cum. Bull. 8.

[5]Ephraim Banks, 17 T.C. 1386, 1392 (1952).

was controlling in making this determination, and a grant was excluded from gross income as a gift only if the grantor had an underlying donative intent to further the recipient's education rather than to engage the recipient's services for the promotion of the grantor's self-interest.[6] Whatever educational motives the recipient may have had in accepting the grant were irrelevant to this analysis.[7]

This situation required a case-by-case determination of whether each particular scholarship was a gift or compensation. This case-by-case method generated inconsistent decisions and substantial confusion as to the tax status of educational grants. Congress attempted to dispel the prevailing confusion by specifically providing, in section 117 of the Internal Revenue Code of 1954, for the exclusion of scholarships and fellowships from gross income. This addition to the tax laws rendered the Code provisions pertaining to gifts inapplicable to scholarships and fellowships. According to the Treasury Regulations, the present tax status of educational grants is governed exclusively by section 117.[8]

By providing specifically for the exclusion of scholarships and fellowships from gross income, Congress intended to establish clear rules for determining excludability.[9] Section 117(a) states that gross income does not include any amount received by an individual as a scholarship at an educational institution or as a fellowship grant. This exclusion applies to the value of services or accommodations received as well as to monetary grants. In addition, amounts received to cover travel, research, clerical, or equipment expenses incidental to such grants are also excluded from gross income to the extent that such amounts actually are expended by the recipient.

Although the general exclusionary provision in section 117 appears to be relatively straightforward, its application is complicated by statutory limitations and exceptions to these limitations.[10] Section 117 was not intended to afford a tax shelter for

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[6]George W. Stone, 23 T.C. 254, 261 (1954).

[7]Ti Li Loo, 22 T.C. 220, 225 (1954).

[8]Treas. Reg. § 1.117-1(a) (1956); Rev. Rul. 72-168, 1972-1 CUM. BULL. 37 (the gift exclusion, INT. REV. CODE of 1954, § 102, does not apply to scholarship grants); Rev. Rul. 72-163, 1972-1 CUM. BULL. 26 (the exclusion of prizes awarded for educational achievement, INT. REV. CODE of 1954, § 74, does not apply to scholarship grants).

[9]H.R. REP. No. 1337, 83d Cong., 2d Sess. 16 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 17 (1954).

[10]INT. REV. CODE of 1954, § 117, provides:

(b) Limitations.—

(1) Individuals who are candidates for degrees.—In the case of an individual who is a candidate for a degree at an educational

payments which are in effect compensation for services rendered or which merely represent a continuing salary during a period when the recipient is on leave from his regular job.[11] The limitations expressed in section 117(b) were designed to further this

institution (as defined in section 151 (e) (4)), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

(2) Individuals who are not candidates for degrees.—In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) Conditions for exclusion.—The grantor of the scholarship or fellowship grant is—

(i) an organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(ii) a foreign government,

(iii) an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

(iv) the United States, or an instrumentality or agency thereof, or a State, a territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) Extent of exclusion.—The amount of the scholarship or fellowship grant excluded under subsection (a) (1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)).

[11] H.R. REP. No. 1337, 83d Cong., 2d Sess. 17 (1954).

The House version of the bill to enact section 117 contained a provision excluding grants to non-degree candidates only if the annual amount received plus any compensation from the recipient's former employer was less than 75% of the recipient's salary in the year preceding the grant. *Id.*

This provision was replaced by the Senate Finance Committee with the present $300, 36-month limitation because of a fear that the House formula might subject grants which were clearly not a continuing salary to income taxation merely as the result of a lack of substantial earned income in the previous year. S. REP. No. 1622, 83d Cong., 2d Sess. 18 (1954).

policy by allowing the exclusion of genuine scholarships and fellowships from gross income, while denying an exclusion to any portion of a grant which is compensation for the performance of services.

Congress did not envision that the limitations expressed in section 117(b) would result in the income taxation of grants which involve services performed primarily for the training and education of the recipient, or which merely supplement an individual's own funds and enable him to further his educational development.[12] The Senate Finance Committee added the specific exception that services required as a condition to receiving a particular degree are not to be considered part-time employment. The purpose of this addition was to make it clear that services which constitute part of the regular curriculum or course of study are not within the scope of the limitation on excludability.[13]

Despite the presence of this express exception, grants conditioned upon the performance of services which are also a degree requirement have not been excluded ipso facto from gross income. The courts have sustained the Internal Revenue Service's position that section 117 is not a mechanical test and have required an initial determination that the grant possesses the characteristics of a scholarship or fellowship before the limitations or exceptions can be considered.[14]

Because of this construction, only the terminology used to express the problem has changed since the enactment of section 117. Before 1954, the problem was determining whether an educational grant possessed the characteristics of a gift. Today, the controversy revolves around what constitutes a scholarship or fellowship grant or, more precisely, what does not constitute such a grant.

There is no definition in section 117 of the terms "scholarship" and "fellowship." The Treasury Regulations, however, have adopted the commonly accepted usage[15] that a scholarship is an

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[12]H.R. REP. No. 1337, 83d Cong., 2d Sess. 17 (1954).

[13]S. REP. No. 1622, 83d Cong., 2d Sess. 189 (1954).

[14]Rev. Rul. 71-379, 1971-2 CUM. BULL. 100; Rev. Rul. 71-378, 1971-2 CUM. BULL. 95; Rev. Rul. 63-250, 1963-2 CUM. BULL. 79.

See, e.g., Steinmetz v. United States, 343 F. Supp. 384 (N.D. Cal. 1972); Edward A. Jamieson, 51 T.C. 635 (1969); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061 (1968); Stephen L. Zolnay, 49 T.C. 389 (1968); Elmer L. Reese, 45 T.C. 407 (1966).

[15]The dictionary definition of scholarship is a sum of money offered by an educational institution, a public or private organization, or foundation to enable a student to pursue his studies at a college, university, or school. WEBSTER'S NEW INTERNATIONAL DICTIONARY 2031 (3d ed. 1961).

The dictionary definition of fellowship is a sum of money offered

amount paid for the benefit of a student at an educational institution to aid in the pursuit of undergraduate or graduate study,[16] and a fellowship is an amount paid for the benefit of an individual who is not a degree candidate to aid in the pursuit of study or research.[17] Although these terms have distinct definitions in the Regulations and separate sets of limitations are imposed by section 117(b), the excludability of a grant which requires the performance of services is not affected, as a practical matter, by the recipient's status as a degree candidate. Therefore, the terms scholarship and fellowship may be used interchangeably for the purposes of this discussion.

The major problem in determining whether a grant is a scholarship arises not so much from the definitions themselves as from the restrictions which the Treasury Regulations impose upon these definitions. Under the Regulations, an amount paid to aid an individual in the pursuit of studies or research is, nevertheless, not a scholarship if it represents compensation for past, present, or future employment services, or for services which are subject to the direction or supervision of the grantor.[18] Similarly, a grant is not a scholarship if the recipient engages in study or research which is of primary benefit to the grantor.[19] Only if the primary purpose of study or research is to further the education and training of the recipient in an individual capacity does the grant qualify as an excludable scholarship.[20]

The primary purpose test does not appear in the Internal Revenue Code, and the legislative history to support the adoption of a restriction of this nature is scant. The House Ways and Means Committee report on section 117 mentions services performed primarily for the education and training of the recipient only in the context of an *exception* to the rule that payments which are, in effect, wages for services are taxable income.[21] There is no mention in the Congressional reports of any restrictions on or tests for the excludability of scholarships other than those which are found in section 117 as enacted.[22]

Because of the incorporation of the primary purpose test, the Treasury Regulations to section 117 have been subjected to

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by an educational institution, a public or private organization, or foundation, for advanced study, research or creative writing. *Id.* at 836.

[16]Treas. Reg. § 1.117-3(a) (1956).

[17]*Id.* § 1.117-3(c).

[18]*Id.* § 1.117-4(c)(1).

[19]*Id.* § 1.117-4(c)(2).

[20]*Id.* § 1.117-4(c).

[21]H.R. REP. No. 1337, 83d Cong., 2d Sess. 17 (1954).

[22]An extensive treatment of the legislative history of section 117 is found in Elmer L. Reese, 45 T.C. 407 (1966).

extensive criticism by commentators. The basis of many of these complaints is that the primary purpose test is merely a continuation of the old gift-or-compensation test which was rejected by Congress.[23] Under the primary purpose test, as under the gift test, the controlling factors are the intent of the grantor in making the grant and whether any benefit inures to the grantor.[24]

It has been proposed that scholarships should be treated differently from gifts and compensation because of the unique elements of motive and party relationship which characterize each.[25] By providing that the term scholarship does not include an educational grant by a grantor motivated by family or philanthropic considerations, the Treasury Regulations seem to recognize that scholarships and gifts are distinct types of transfers.[26] Further, with the enactment of section 117, it no longer follows, even if the primary purpose test is used, that scholarship grants are included in gross income merely because payment is compensatory in nature: If the primary purpose of the grant is to further the

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[23]*See e.g.*, 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.42, at 7-146, 7-148 (rev. ed. 1974); Hutton, *Scholarships and Fellowships: What's in a Name?*, 56 A.B.A.J. 592, 593 (1970); Myers, *Supreme Court, in Unenlightening Decision, Holds "Scholarship" Taxable*, 31 J. TAXATION 20 (1969); Myers, *Tax Status of Scholarships and Fellowships*, 22 TAX LAW. 391, 398 (1968); Tabac, *Scholarships and Fellowship Grants: An Administrative Merry-Go-Round*, 46 TAXES 485, 488 (1968); Mutino, Book Review, 59 KY. L.J. 589, 594 (1970).

A bill which would have added a primary purpose test was introduced to clarify the rule but was rejected by Congress. S. REP. No. 2207, 87th Cong., 1st Sess. (1961).

[24]It has been suggested that the identity and intent of the grantor are irrelevant because section 117(b)(1) provides a mechanical test for determining whether grants that require the performance of services are to be considered as nontaxable scholarships. Tabac, *Scholarships and Fellowship Grants: An Administrative Merry-Go-Round*, 46 TAXES 485, 490 (1968). The courts, however, have sustained the position that section 117 is not a mechanical test. *See* cases cited at note 14 *supra*.

It has also been suggested that the mere presence of a benefit to the grantor may not be a useful standard in the context of research grants provided by charitable and governmental organizations for the purpose of rendering a public service rather than obtaining a direct economic benefit from the services of the recipient. 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.42, at 7-149 (rev. ed. 1974).

[25]Scholarships and fellowships are characterized by motives of encouraging education and benefiting society through grants to unrelated parties where the grantor does not direct the grantee's activities. Compensation is given for reasons of self-interest to unrelated parties where the grantor directs the grantee's activities. Gifts, on the other hand, are given to relatives or friends because of affection or appreciation. Gordon, *Scholarship and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144, 152-53.

[26]Treas. Reg. § 1.117-3(a), (c) (1956).

education of the recipient in an individual capacity, the grant is excluded.[27] The distinction is made between amounts paid primarily in return for services rendered and amounts paid primarily to further the education of the individual.[28] Therefore, section 117 affords a reasonable basis for determining the character of educational grants if the opportunity for considering scholarships as a distinct type of transfer is utilized, instead of trying to force such grants into the narrow, polar mold required by the either-gift-or-else-compensation concept.[29]

The Treasury Regulations have been called confusing, inconsistent, and ambiguous, and have been denigrated for failing to remedy the problems of statutory construction and to establish clear tests for determining which payments qualify as scholarships.[30] Despite this lack of support from the legal community, the United States Supreme Court in *Bingler v. Johnson*[31] sustained the Treasury Regulations' definitions of scholarships and fellowships. The Court's decision was based upon the premise that there can be no scholarship if a quid pro quo is given by the recipient.[32] On a philosophical level, the primary purpose test also has been defended on the ground that the arguments for using a compensation policy approach are more compelling than those favoring a policy of tax relief which could result in economic inequality. It is feared that disregarding the compensation argument would result in abuses, especially in the area of

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[27]William Wells, 40 T.C. 40, 49 (1963); Frank T. Bachmura, 32 T.C. 1117, 1125 (1959); Myers, *Supreme Court, in Unenlightening Decision, Holds "Scholarship" Taxable*, 31 J. TAXATION 20, 25 (1969).

[28]William Wells, 40 T.C. 40, 49 (1963).

[29]Gordon, *Scholarships and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144, 157.

[30]Myers, *Supreme Court, in Unenlightening Decision, Holds "Scholarship" Taxable*, 31 J. TAXATION 20 (1969); Comment, *Taxability of Scholarships and Fellowships*, 35 MO. L. REV. 393, 404 (1970).

Another criticism which has been raised is that, although section 117 provides different rules for the treatment of grants to persons who are degree candidates and grants to persons who are not, the Regulations do not distinguish between these two categories. The primary purpose test is applied to each class although the view that the terms scholarship and fellowship connote a purpose of assistance distinct from the self-interest of an employer in compensating an employee is a correct statement of Congressional intent only in the case of a non-degree candidate. S. REP. No. 1622, 83d Cong., 2d Sess. 18 (1954); Tabac, *Scholarships and Fellowship Grants: An Administrative Merry-Go-Round*, 46 TAXES 485, 489 (1968). Section 117(b)(1) specifically provides for a class of services performed by degree candidates which does not give rise to an employment relationship.

[31]394 U.S. 741 (1969).

[32]*Id.* at 751.

wage continuation plans which are, in effect, merely employee training programs.[33]

Thus, even though Congress intended to provide clear-cut rules to alleviate the difficulties of determining the taxability of educational grants,[34] the convoluted limitation on the exclusion of scholarships from gross income, the failure of Congress to define the terms "scholarship" and "fellowship," and the additional requirements imposed by the Regulations have resulted in continuing litigation, and the unpredictability, confusion, and inconsistencies of the pre-1954 determinations have continued unabated.[35] This has led to the designation of section 117 as "something of a fun house with traps for the unwary and prizes for the imaginative."[36] Since there are no indications that the current Regulations will be modified,[37] the problem facing the tax planner is how to avoid the traps and gain the prize of excludable income. The solution to the problem lies in determining what characteristics a grant requiring the services of the recipient must possess before it qualifies as a scholarship or fellowship under the present interpretation of section 117.

II. University As Grantor

A. Research Assistantships

It is common for universities to grant stipends to candidates

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[33]Large corporations have an advantage over small employers in competitive hiring by being able to offer employee educational leaves with continuing tax free payments which approximate the employee's salary. Such "scholarships" are essentially employment arrangements. 21 Ala. L. Rev. 375, 386 (1969).

[34]H.R. Rep. No. 1337, 83d Cong., 2d Sess. 16 (1954); Myers, *Supreme Court, in Unenlightening Decision, Holds "Scholarship" Taxable*, 31 J. Taxation 20 (1969); Tabac, *Scholarships and Fellowship Grants: An Administrative Merry-Go-Round*, 46 Taxes 485, 490 (1968).

[35]In fact, the most recent Revenue Ruling on the subject states that whether a grant is included in gross income depends on the facts and circumstances under which the payments are made. Rev. Rul. 72-263, 1972-1 Cum. Bull. 40.

Compare Pappas v. United States, 67-1 U.S. Tax Cas. ¶ 9386 (E.D. Ark. 1967), *and* William Wells, 40 T.C. 40 (1963), *with* Woddail v. Commissioner, 321 F.2d 721 (10th Cir. 1963), *and* Ethyl M. Bonn, 34 T.C. 64 (1960). *Compare* Aileene Evans, 34 T.C. 720 (1960), *with* Bingler v. Johnson, 394 U.S. 741 (1969).

[36]Myers, *Tax Status of Scholarships and Fellowships*, 22 Tax Law. 391, 393 (1968).

[37]The Internal Revenue Service has indicated that it intends to amend the Regulations to reflect decisions holding that stipends qualify as scholarships. Nothing, however, has come of these indications. Rev. Rul. 65-146, 1965-1 Cum. Bull. 66; Rev. Rul. 65-59, 1965-1 Cum. Bull. 67; Rev. Rul. 63-250, 1963-2 Cum. Bull. 79.

for Master of Science, Master of Arts, and Doctor of Philosophy degrees. As a condition to receiving a grant, the candidate often is required to perform research or teaching services at the university. The stipend usually is designated as a research or teaching assistantship.

Typically, a graduate student receiving a research assistantship in the physical sciences is expected to perform laboratory work on various research problems under the direction of a faculty member.[38] In the social sciences, a research assistant performs library or survey type research which leads to a publishable paper on the topic considered.[39] At the beginning of a student's graduate schooling, research problems are defined by a supervising professor and fall within the area of the student's interest and educational goals. A student may gain research experience by working on problems under several professors during this period. When the student has acquired sufficient course work and research experience, a thesis problem is selected subject to faculty approval. Subsequent research is devoted to solving the thesis problem and writing a dissertation on the subject. This work generally is carried out independently by a student with guidance from a single professor.

The amount of time a research assistant must devote to working varies from university to university and department to department. Some departments require graduate assistants to work twenty hours per week, while others fix no time requirement. In any case, the major emphasis is placed upon course work

[38]The description of the research assistantship is a composite picture of the programs operated by the Biochemistry, Microbiology, and Pharmacology Departments of Indiana University-Purdue University at Indianapolis [hereinafter referred to as IUPUI], the Psychology Department of Purdue University, and the Chemistry and Metallurgy Departments of Iowa State University. It represents a typical assistantship program. Each of these departments offers both a Master of Science and a Doctor of Philosophy degree. The handling of the assistantships is similar regardless of the degree for which the recipient is a candidate.

[39]Research assistantships in the social sciences under which the graduate student works on a thesis problem are rare. To the extent that such assistantships are offered, the income tax status of the stipend received by the graduate assistant is governed by the same criteria as payments to research assistants in the physical sciences. Normally, however, in the social sciences the term "research assistant" means a student doing source checking, footnote checking, interviewing, etc., for a professor who is doing the original work on the project. The student is considered to have a part-time job for which he receives compensation. Interviews with Prof. Donald J. Gray, Department of English, Indiana University, in Bloomington, Indiana, May 14, 1975; and Prof. Sheldon Stryker, Chairman of the Department of Sociology, Indiana University, in Bloomington, Indiana, May 14, 1975.

during the first two years of a doctoral program. Afterwards, less time is spent in the classroom, and research consumes an increasing portion of a student's time. In a master's degree program, the time spent in each phase is correspondingly less than in a program leading to a doctoral degree. A research assistantship continues throughout both of these periods. Regardless of the working time required, a student is expected to work at full capacity and to demonstrate an ability to implement successfully an independent research program.

Research work leading to the completion of a thesis project and to the writing and defense of a dissertation is required of all candidates for a doctoral degree regardless of the field of study and regardless of whether a student receives an assistantship stipend. Similar research is also a requirement of most master's degree programs.[40] Thus, in nearly every case the research performed by a research assistant is used to fulfill the degree requirement of writing and defending a dissertation. Additionally, academic credit is given for performing such research and is applied to the number of credits required for the degree.[41] The purpose of these requirements is to expose a student to the type of activity in which he will be engaged upon receiving his degree. The programs are designed to supplement formal course work with a variety of professional activities geared to the individual needs and professional aspirations of each student.

Graduate assistants are selected on the basis of academic qualifications and potential for satisfactorily completing the degree requirements. Thus, the best students receive assistantships. Financial need seldom enters into the selection process. However, the purpose of the assistantship program is to aid the student in completing his education, and it is considered that the vast majority of students experience financial need.

A typical graduate assistantship stipend provides between $250 and $350 per month. Funds for these grants are provided by a variety of foundations and governmental sources. These

[40]Some master's degree programs, for example, the Master of Science programs in the Departments of Pharmacology at IUPUI and Psychology at Purdue University, have an option whereby the student can elect to complete an expanded course requirement and demonstrate a reading knowledge of a foreign language in lieu of a thesis. Thus, it cannot strictly be said that research is a requirement for all candidates for the degree, although such research is a requirement for all candidates electing the thesis option. Interview with Prof. S.R. Wagle, Department of Pharmacology, IUPUI, in Indianapolis, May 8, 1975; PURDUE UNIVERSITY, 1974-1976 GRADUATE SCHOOL BULLETIN 295.

[41]Generally the department offers a course entitled "research" and the student enrolls in this course for a specified number of hours.

funds travel two basic paths from an original grantor to a graduate assistant. An individual professor may apply directly to a grantor for funds to support the professor's research project.[42] The funds from each grant are then held in a separate account and used to cover expenses of the particular projects, including stipends to graduate assistants. Alternatively, funds may be given to a university for the maintenance of a research facility in a particular field.[43] The university then holds the funds in a general budgetary account to be administered in support of its research goals. In this circumstance, graduate assistantship stipends are paid from the same account as the professors' salaries. Regardless of which funding method is employed, the withholding of taxes from the stipends depends upon the administrative practices of the university or department involved.

Whether a research assistantship is a scholarship excludable from gross income depends upon whether the stipend meets the limitations of section 117(b)(1).[44] In particular, the scholarship exclusion does not apply to any amount which represents payment for teaching, research, or other services in the nature of part-time employment. If these services are required of all candidates for a particular degree, however, the services are not considered part-time employment. Since a nearly universal condition to receiving a graduate degree is that a candidate perform original research, write a thesis based upon his research project, and defend the thesis, research assistantships seem squarely within the scope of the scholarship exclusion. Significantly, a 1956 Revenue Ruling provides that a grant made by a foundation to enable the recipient to complete the necessary research and dissertation for a doctoral degree is excludable from gross income even though the grantor may derive some benefit from the research.[45] This ruling, however, is subject to the qualification that the primary

[42]For example, the graduate assistantship programs in Biochemistry and Microbiology at IUPUI are funded in part by National Institutes of Health grants to the professors. The terms of such grants vary widely. Some such grants specify the particular research project supported, and others merely define the general field to which the funds may be applied. Interviews with Prof. Donald Bowman, Department of Biochemistry, IUPUI, in Indianapolis, May 5, 1975; and Prof. Jack Bauer, Department of Microbiology, IUPUI, in Indianapolis, May 5, 1975.

[43]For example, the Atomic Energy Commission has established the Ames Laboratory on the campus of Iowa State University. This laboratory is supported by Commission funds administered by the University. The laboratory conducts extensive research in the fields of chemistry, physics, and metallurgy, and supports the University's graduate assistantship programs in these fields.

[44]INT. REV. CODE of 1954, § 117(b)(1). See note 10 *supra*.

[45]Rev. Rul. 56-419, 1956-2 CUM. BULL. 112.

purpose of the grant must be to further the recipient's education and training. Moreover, the recipient must have no commitment to the grantor regarding his course of study or the research subject matter. Thus, insistence upon the primary purpose test makes uncertain the exclusion of even this type of grant.

An argument has been advanced that the limitations of section 117(b)(1) provide a mechanical test for determining whether a grant is a scholarship. The mechanical test rationale dictates that an amount received for performing services required as a condition to receiving a degree should be excluded without regard to the primary purpose test. This argument is based upon the rule of statutory construction which states that the expression of some limitations prevents additional restrictions from being implied. This interpretation of section 117, however, has been rejected. Thus, before the exclusion comes into play, there must be a threshold determination that the grant has the normal characteristics of a scholarship.[46] Since a dual benefit is often involved in graduate assistantship grants, the determination of the primary purpose necessarily depends upon the facts and circumstances of each particular case.[47]

In *Chandler P. Bhalla,*[48] a typical research assistantship was found to have the characteristics of an excludable scholarship. In *Bhalla,* a doctoral degree candidate in physics received from the university a research assistantship financed by a National Science Foundation grant. The court held that the assistantship stipend was an excludable scholarship and stated that services constituting part of the regular curriculum or course of study leading to a degree were not includable within the statutory limitations on the exclusion.[49] Since *Bhalla,* research assistantships having substantially the same characteristics generally have been excluded from gross income without difficulty.[50]

When a scholarship exclusion is claimed for income tax purposes, it is advantageous to include supporting information with the tax return.[51] This documentation should consist of a letter from the student stating that he was enrolled as a graduate student at the particular university for the period involved and re-

[46]Bingler v. Johnson, 394 U.S. 741, 749 (1969); Elmer L. Reese, 45 T.C. 407, 413 (1966).

[47]Chandler P. Bhalla, 35 T.C. 13, 17 (1960).

[48]35 T.C. 13 (1960).

[49]*Id.* at 15.

[50]Cases substantially identical on the facts to *Bhalla* will be disposed of in accordance with that decision. Rev. Rul. 63-250, 1963-2 CUM. BULL. 79.

[51]This procedure has been followed by graduate students in chemistry and metallurgy at Iowa State University who have been successfully claiming scholarship exclusions of research assistantship stipends for more than ten years.

ceived a specific monetary stipend for research activity necessary for the degree. The letter should also state that the income is nontaxable under section 117 of the Internal Revenue Code of 1954 as interpreted in *Chandler P. Bhalla,* 35 T.C. 13 (1960). A separate letter from the department chairman should also be included, stating the above information and further stating that, as part of the training program, the student held an appointment as a graduate assistant[52] for which the student received from the university a specific monetary stipend, that all graduate students are required to perform research as a condition to receiving the degree, that the research performed by the graduate assistant is considered to be a valuable and integral part of his training, and that the research is designed to contribute to the training of the student rather than to benefit the granting entity.

When a grant differs significantly in any respect from those previously described, great difficulty is encountered in convincing the Internal Revenue Service and the courts that the stipend possesses the normal characteristics of a scholarship. Two criteria are essential for a decision in favor of the taxpayer. First, the recipient must receive academic credit for research work performed as a condition to receiving the grant. Secondly, similar research activities must be required of all candidates for the degree whether or not they receive assistantships.[53] Satisfaction of these requirements does not guarantee that a grant will be excluded from gross income,[54] but failure to satisfy them is fatal to a taxpayer's case.[55]

It is not sufficient that the required research merely have a close relationship to the recipient's academic interests or that the payments constitute a form of financial aid that enables the recipient to continue his studies. Reasonable equivalent activities and identity of work patterns for all degree candidates, whether or not they receive stipends, is also required. When the grant recipient performs a different type of research, assumes different responsibilities, or is required to spend more time than degree candidates generally, the stipend is considered compensation for services rendered.[56] It also is helpful if the work performed is directly applicable to the recipient's educational objec-

[52]In drafting these letters, the words "employed," "employment," and "salary" should be carefully avoided.

[53]*See, e.g.,* Lawrence Spruch, 20 CCH Tax Ct. Mem. 324 (1961); Chandler P. Bhalla, 35 T.C. 13 (1960).

[54]*See, e.g.,* Karl Laurence Kirkman, 29 CCH Tax Ct. Mem. 797 (1970); Stephen L. Zolnay, 49 T.C. 389 (1968).

[55]Alex L. Sweet, 40 T.C. 403 (1963).

[56]Stephen L. Zolnay, 49 T.C. 389, 396 (1968).

tives and interests and thus can be said to be an integral part of the regular curriculum leading to the degree.[57]

Research performed is generally utilized in a student's dissertation. This constitutes evidence that the research is applicable to the student's education and course of study. Mere use of the results of the research in fulfilling the dissertation requirement, however, is not sufficient to demonstrate conclusively that the primary purpose of a grant is to further the recipient's education, particularly when the evidence as a whole suggests that an employment relationship exists. For example, in *Kreis v. Commissioner*,[58] a graduate student who received a stipend while participating in a research project to study the causes of school dropouts, was denied an exclusion. The research project was funded by a United States Office of Education grant to the local school board, which paid stipends to the project staff members. Although the research was supervised by several university professors and the results were used by the student in his thesis, the stipend was found to be compensation since there was no degree requirement that he perform *compensated* services amounting to a part-time job.[59]

The fine line between grants which qualify as scholarships and those which are construed to be compensation is demonstrated by cases in which a university has a research contract with the original grantor, whose funds the university is administering.

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[57]Lawrence Spruch, 20 CCH Tax Ct. Mem. 324, 326 (1961); Chandler P. Bhalla, 35 T.C. 13, 15 (1960).

[58]441 F.2d 257 (4th Cir. 1971), *aff'g* 29 CCH Tax Ct. Mem. 770 (1970).

[59]Similarly, stipends paid to two graduate students who worked on a highway construction research project for the Alabama Bureau of Roads, and a land rights research project for the Nebraska Soil and Water Conservation Commission, were found to be compensation, although the doctoral degree candidates used the results of the research as a basis for their theses. John B. Karrh, 32 CCH Tax Ct. Mem. 88 (1973); John W. Klein, 32 CCH Tax Ct. Mem. 301 (1973).

The stipend paid a graduate student in business while working on a project in the political science department also was found to be compensation. Here the results of the research were used in a paper required in a psychology course. Charles F. Wall, 31 CCH Tax Ct. Mem. 1069 (1972).

Dilatoriness in pursuit of a degree also casts suspicion on whether the actual purpose of the research is to fulfill the degree requirements or to fulfill the duties of an employee. The student took seven years to attain his Doctor of Philosophy degree and did not choose a disseration topic until five years after he began work, although this work was in fact used in the dissertation. It was determined that since it was uncertain whether this research would ultimately be used in the dissertation, the work did not have the proper purpose. The student's major error, however, appears to have been giving his occupation as "engineer" on his tax return. Stephen L. Zolnay, 49 T.C. 389 (1968).

When the services required of a grant recipient are directly related to the fulfillment of such a contract, they may be considered to play an essential role in meeting the laboratory commitments of the university. This result occurs if a court, on the basis of the evidence as a whole, determines that the payments are essentially compensation paid for the purpose of benefiting the university.[60] If a court feels that a grant in these circumstances is a scholarship, however, the contract is classified as an opportunity for research which is not available under the regular university budget and which furthers the university's obligation to contribute to human knowledge and education. The payments are then deemed "aimed to benefit academically qualified students so that they would not need to divert their energies from scholarly activities."[61]

The number of working hours required of students and the amount of supervision exercised over them also are factors which have been used to support both sides of this argument. The requirement of a work week of approximately forty hours does not necessarily indicate an employment relationship if academic credit is received by a student for work performed. When such a requirement is coupled with a regular, planned time schedule for performing the work, however, support is given to a finding that the relationship is essentially one of employment.[62]

The importance of supervision to this determination depends upon who does the supervising. For example, supervision by a

[60]The student was doing research for a laboratory division of the electrical engineering department which received funds for stipends and other research costs from various contracts and grants. Stephen L. Zolnay, 49 T.C. 389 (1968). This case was followed by Rev. Rul. 69-425, 1969-2 CUM. BULL. 16, which provided that where the taxpayer was hired by a university to conduct research under a contract entered into by the university with a government agency, the taxpayer's activities were conducted primarily for the benefit of the university. Consequently, amounts received by the taxpayer were not excludable as a scholarship.

[61]Lawrence Spruch, 20 CCH Tax Ct. Mem. 324, 326 (1961). The student was working under a professor who had received a Signal Corps contract for a specific proposal.

[62]Where thirty-five hours of work per week were required and more hours were actually worked, the grant was found to be a scholarship. Lawrence Spruch, 20 CCH Tax Ct. Mem. 324 (1961). Where forty hours of work per week were required and more hours were actually worked, the grant was found to be compensation. The court felt that this was in excess of the research time expected of degree candidates. Stephen L. Zolnay, 49 T.C. 389 (1968).

In *Zolnay* the fact that the work was done on a planned time schedule weighed more heavily than the actual number of hours worked. From the author's experience, the research time expended by graduate students in chemistry, for example, usually is in excess of forty hours per week but is worked in a highly irregular pattern.

grantor is indicative of an employment relationship since the grantor exercises direction and control over the recipient's activities. The Treasury Regulations accompanying section 117 state that any amount paid to enable the recipient to pursue studies or research is not a scholarship if the amount represents payment for services subject to the direction or supervision of the grantor.[63] Conversely, extensive supervision indicates that the services rendered are primarily a learning experience since the burden of providing supervision offsets the benefits gained from the services.[64] It is unsettled whether work performed under a grant from one organization and filtered through a second agency which supervises the recipient comprises work subject to the supervision of the grantor. The motives of the second agency are important in this situation. If the payments are made by the university in which the recipient is enrolled, from funds derived through other sources, an argument can be advanced that these payments are disbursed by an entity interested in the recipient's education. Depending upon the circumstances as a whole, this argument may or may not be successful.[65]

The reasoning of many courts in cases involving scholarships is pinioned upon the determination of a nebulous item—the policy of the university toward the student-recipient. The argument employed is rather circular. A grant is considered a scholarship if its primary purpose is to further the education and training of the recipient in an individual capacity rather than to benefit the university. The primary purpose is ascertained from the university's classification of the recipient as a student or an employee. This, in turn, is determined by the purpose of the services—whether they are intended to provide training for the student or benefit the university.[66]

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[63]Treas. Reg. § 1.117-4(c)(1) (1956).

[64]Robert H. Steiman, 56 T.C. 1350, 1356 (1971).

In some cases lack of extensive supervision by the university has been held to be an indication that the services rendered were not intended to be part of the education and training of the recipient. Edward A. Jamieson, 51 T.C. 635 (1969); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061 (1968); Elmer L. Reese, 45 T.C. 407 (1966).

[65]Grants to a university or a professor with the ultimate recipient working under a professor are not considered to be supervised by the grantor. Lawrence Spruch, 20 CCH Tax Ct. Mem. 324 (1961); Chandler P. Bhalla, 35 T.C. 13 (1960).

Grants to a laboratory associated with a university or to a school board with the ultimate recipient working under a professor are considered to be supervised by the grantor. Stephen L. Zolnay, 49 T.C. 389 (1968); Kreis v. Commissioner, 441 F.2d 257 (4th Cir. 1971), *aff'g* 29 CCH Tax Ct. Mem. 770 (1970).

[66]*See, e.g.*, Robert H. Steiman, 56 T.C. 1350 (1971) (stipend was held

Several factual criteria indicate the basic policy of the university. These include statements in brochures describing assistantship programs and statements of university officials explaining that the primary function of graduate assistantships is to enable students to pursue their studies and that assistantships are considered a vital part of a student's training.[67] The type of services required must support these statements.

The role of financial need in selecting grant recipients is another important factor. When financial need, rather than research ability or experience, is used as a basis for selection, the grant is characterized as a scholarship.[68] Conversely, when only academic or professional criteria are used to select recipients, a university indicates that its needs, rather than those of the student, are of primary importance.[69] A taxpayer may prevail, however, even though a grant is given without regard to financial need, if the selection is based upon academic ability and the university assumes that students generally are in need of money.[70] If a university gives other scholarships and fellowships and requires no concomitant services, however, the question is raised whether an assistantship is also a scholarship or whether the stipend is merely compensation for services. Using separate qualifications for and administration of grants requiring services also makes them suspect.[71] As with most other elements considered in determining whether a grant has the characteristics of a scholarship, separate administration of assistantships is not conclusive proof that a grant represents compensation.[72]

Numerous practices in the general administration of assistantship grants have been isolated by some courts as evidence that a grant is compensation, but the same practices have been consid-

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to be a scholarship); Stephen L. Zolnay, 49 T.C. 389 (1968) (stipend was held to be compensation).

It has been suggested in all seriousness that a grant which represents compensation can be distinguished on the facts from those cases in which the grants are scholarships because the study and research involved in the scholarship situation serve the primary purpose of furthering education and training and the payments do not represent compensation. Karl Laurence Kirkman, 29 CCH Tax Ct. Mem. 797, 810 (1970).

[67]*See, e.g.*, Robert H. Steiman, 56 T.C. 1350 (1971).

[68]*Id.* at 1355. Where the student is selected to work on a project because of prior experience, rather that for academic performance or financial need, any training received by the student is considered to be incidental to, and for the purpose of, facilitating work on the project. Charles F. Wall, 31 CCH Tax Ct. Mem. 1069 (1972).

[69]Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061, 1065 (1968).

[70]Lawrence Spruch, 20 CCH Tax Ct. Mem. 324, 326 (1961).

[71]Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061, 1066 (1968); Donald R. DiBona, 27 CCH Tax Ct. Mem. 1055, 1060 (1968).

[72]Robert H. Steiman, 56 T.C. 1350, 1356 (1971).

ered unimportant in other cases. These factors seem to make no real difference in the outcome of a case and are mentioned by courts only as additional support for decisions against taxpayers. These practices include the paying of assistantships through a university payroll office from general funds, rather than from earmarked funds.[73] Income tax withholding is always mentioned as a factor supporting a decision against the taxpayer.[74] Furthermore, graduate assistants often receive fringe benefits, such as sick leave, paid vacations, medical insurance, or retirement plans, which are similar to those given full-time faculty members.[75] The greater the similarity between the treatment of students and regular employees, the more likely it becomes that assistantship stipends will be considered compensation. A graduate assistant's failure to receive fringe benefits, however, is not in itself sufficient to show that the grant is not compensation.[76]

The size of payments received under graduate assistantship grants is subject to paradoxical judicial analysis. If the amount received is large relative to amounts generally paid as scholarships and if it approximates salaries paid for the same work, the stipend may be considered compensation.[77] On the other hand, if an amount is smaller than that paid regular employees, the stipend also may be compensation on a theory that a benefit flows to the university since it would have had to hire employees at higher salaries if no graduate assistants were available.[78] In one decision, an assistantship stipend greater than the amount ordinarily paid as employee wages was held to be a scholarship since it was apparent that if the objective of the university had been to relieve

[73]*See, e.g.*, Robert H. Steiman, 56 T.C. 1350 (1971) (excludable scholarship); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061 (1968) (taxable compensation); Lawrence Spruch, 20 CCH Tax Ct. Mem. 324 (1961) (excludable scholarship).

[74]*See, e.g.*, Stephen L. Zolnay, 49 T.C. 389 (1968). The importance of this factor has been minimized, however, by judicial recognition that a university may withhold tax solely to protect itself from a possible penalty for failure to perform a duty in an area in which the law is not clearly defined. Robert H. Steiman, 56 T.C. 1350, 1357 (1971); Chandler P. Bhalla, 35 T.C. 13, 17 (1960).

[75]*See, e.g.*, Robert H. Steiman, 56 T.C. 1350 (1971) (excludable scholarship); Stephen L. Zolnay, 49 T.C. 389 (1968) (taxable compensation).

[76]Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061, 1065-66 (1968).

[77]Stephen L. Zolnay, 49 T.C. 389, 398 (1968).

[78]Edward A. Jamieson, 51 T.C. 635, 639 (1969).

The Treasury Regulations indicate that where payment is received for services, only the portion of the grant in excess of the rate of compensation ordinarily paid for similar services is excluded as a scholarship. Treas. Reg. § 1.117-2(a) (1956). However, this allocation has not been allowed by the courts, and the entire payment has been considered to be compensation. Elmer L. Reese, 45 T.C. 407 (1966).

the faculty, part-time instructors could have been hired at lower salaries.[79]

In summary, research assistantships paid to graduate students by the university in which the students are enrolled are scholarships and excludable from gross income if the following conditions are satisfied: (1) equivalent research work is required of all degree candidates regardless of whether these students receive assistantships, (2) academic credit is given for the research performed, (3) the type of supervision of the student's activities indicates a learning experience, and the research projects assigned correspond to the student's field of interest and educational objectives, and (4) the research performed is utilized by the students in their theses.

The number of working hours required, the role of financial need in selecting grant recipients, the amount of the stipend, the withholding of income tax from the stipend, and the receipt of fringe benefits by research assistants are factors to be considered in determining whether a grant possesses the normal characteristics of a scholarship or is compensation. However, these factors are not conclusive proof of either result but are evidence of whether a university considers graduate assistants to be students or employees. If grant recipients have many characteristics in common with university employees, the stipend is likely to be compensation. Conversely, if a university treats its research assistants substantially the same as all other graduate students, the stipend probably is a scholarship.

B. Teaching Assistantships

Theoretical differences between research assistantships and teaching assistantships are minimal. Since research assistantship stipends generally are considered scholarships, it would seem logical for courts to treat teaching assistantship stipends in the same manner. This is not the case, however, and teaching assistantship stipends usually are found to be taxable compensation. The income tax treatment of research assistantships is considered an irrelevant analogy to the treatment of teaching assistants.[80] This interpretation is not based upon any intrinsic difference between teaching and research as services but, rather, is predicated upon the factual differences between a university's treatment of research and teaching assistantships and differences in the primary purpose for making the grants.

Typically, a graduate student teaching assistant is expected to perform teaching duties under the supervision of a faculty

[79]Robert H. Steiman, 56 T.C. 1350 (1971).

[80]Donald R. DiBona, 27 CCH Tax Ct. Mem. 1055, 1060 (1968); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061, 1066 (1968).

member in laboratory or classroom courses or both.[81] Laboratory teaching duties may include preparing necessary equipment and supervising and assisting undergraduate students in learning laboratory techniques. Classroom teaching duties consist of lecturing, conducting classroom discussion and recitation, and constructing, administering, and grading examinations. All of these duties are performed under the supervision of a professor having primary responsibility for a course. A professor oversees and approves the preparation of lecture material and examinations, remains in the laboratory during laboratory instruction, and frequently attends lectures given by the teaching assistant. This close supervision of teaching assistants assures both a valuable educational experience for the graduate assistant and quality instruction for the undergraduate student.

The amount of time a teaching assistant is required to work varies considerably. Some departments require up to twenty hours per week, while others fix no minimum time requirement. The amount of time actually spent depends upon the amount of preparation and consultation necessary for the course being taught. Teaching experience, unlike research experience, generally is not a formal degree requirement. While some departments require teaching as a condition to receiving a degree, other departments merely encourage their students to teach. Nevertheless, nearly all graduate students perform some teaching duties as a part of their training.[82] Some departments require either teaching or research experience for each semester during which the student is enrolled. The mix between research and teaching is then determined by the

[81]The description of the teaching assistantship is a composite picture of the programs operated by the Biochemistry, Microbiology, and Pharmacology Departments of Indiana University-Purdue University at Indianapolis [hereinafter cited at IUPUI), the English and Sociology Departments at Indiana University, the Psychology Department at Purdue University, and the Chemistry and Metallurgy Departments at Iowa State University. Each of these departments offers both a Master of Science, or Master of Arts, and a Doctor of Philosophy degree. The handling of the assistantships is similar regardless of the degree for which the recipient is a candidate, except that master's degree candidates receive fewer assistantships since assistantships frequently are not given to first-year students.

[82]Teaching experience is required by the Chemistry Department at Iowa State University, and the Microbiology Department at IUPUI. IOWA STATE UNIVERSITY, 1973-1975 GRADUATE COLLEGE BULLETIN 35; Interview with Prof. Jack Bauer, Department of Microbiology, IUPUI, in Indianapolis, May 5, 1975.

Teaching experience is strongly encouraged, although not required, by the Biochemistry and Pharmacology Departments at IUPUI, and the English and Sociology Departments at Indiana University. Interviews with Prof. Donald Bowman, Department of Biochemistry, IUPUI, in Indianapolis, May 5, 1975; Prof. S.R. Wagle, Department of Pharmacology, IUPUI, in Indianap-

student's professional aspirations.[83] Generally, departments which require teaching experience consider it part of the curriculum and provide corresponding academic credit. These teaching programs supplement formal course work with a variety of professional activities in which the student may engage after receiving his degree. Teaching frequently is considered to be an experience necessary for qualifying a student to hold a doctoral degree, since graduate students are an important source of future university faculties. Between thirty and one hundred percent of all graduate students, depending upon the particular field of study, pursue a teaching career after receiving the doctoral degree.[84]

Graduate assistants are selected on the basis of academic qualifications and potential for satisfactorily completing the degree requirements. Thus, the best students receive assistantships. Financial need seldom enters into the selection process. However, the purpose of an assistantship program is to aid the student in completing his education, and it is considered that the vast majority of students experience financial need.

A typical graduate teaching assistantship stipend provides between $250 to $350 per month and is paid with university funds from a general budgetary account. Teaching grants, therefore, are paid from the same account as university employee salaries. Whether income tax is withheld from the stipend depends upon the administrative practices of the particular university or department involved.

In contrast to the curriculum-oriented training program described above, many universities consider teaching assistants to be associate faculty with full responsibility for the course being taught and treat them as employees rather than strictly as students.[85] In these circumstances, stipends paid to students are tax-

olis, May 5, 1975; Prof. Donald J. Gray, Department of English, Indiana University, in Bloomington, Indiana, May 5, 1975; and Prof. Sheldon Stryker, Chairman of the Department of Sociology, Indiana University, in Bloomington, Indiana, May 14, 1975.

[83]This type of program is carried on by the Psychology Department at Purdue University. PURDUE UNIVERSITY, 1974-1976 GRADUATE SCHOOL BULLETIN 296.

[84]The departments used as examples in this study gave the following estimates of the percentage of graduate students who pursue a teaching career: Biochemistry 70%, Chemistry 30%, English 100%, Microbiology 40%, Pharmacology 50%, Sociology 95%.

[85]For example, beginning graduate assistants in the Department of English at Indiana University have responsibilities similar to those outlined above. As these teaching assistants gain experience, however, the responsibilities increase until, in the third year, such graduate assistants have total responsibility for the course being taught. Interview with Prof. Donald J. Gray, Department of English, Indiana University, in Bloomington, Indiana, May 14, 1975.

able compensation for services, rather than scholarships. Because of the propensity of universities to treat teaching assistants as employees, nearly insurmountable obstacles have been encountered in attempts to show that any teaching stipend possesses the normal characteristics of a scholarship. In *Robert H. Steiman,*[86] however, a case in which a teaching assistantship stipend was found to be a scholarship, these obstacles were circumvented.

In *Steiman,* a doctoral candidate received a typical curriculum-oriented teaching assistantship. The duties required of him were required of all degree candidates in the department, regardless of whether they received assistantships. The teaching duties required were always within the area of the student's interest and study, and academic credit was given. All of the duties required were performed under the direct supervision of a faculty member in charge of the particular course, who also assigned grades for both the undergraduate students and the teaching assistants. In conformance with the instructional nature of the teaching services provided by the graduate students, the professors also made an overall evaluation of the performance and ability of each student, regardless of whether the student received an assistantship. This evaluation was included in the student's file for use in answering inquiries of potential employers.

Several types of financial assistance, including assistantships, trainingships, and scholarships, were available to graduate students. The university stated that the primary purpose of the graduate assistantship program was to enable students to pursue graduate studies, and that an effort was made to provide the student with the kind of aid which would be most beneficial. Financial need, rather than teaching ability or experience, was the primary factor in determining whether financial aid was appropriate in a given case. The stipends paid to teaching assistants ranged from $2500 to $3000 per year, which exceeded the annual salaries paid to part-time instructors.

The fact that teaching assistants were paid more than part-time instructors, coupled with the extensive faculty supervision of the graduate assistant's work, led the *Steiman* court to conclude that the potential benefit of the student's services was not a primary consideration for granting the teaching assistantships.

The Department of Sociology at Indiana University has two types of student teaching positions. The teaching assistantship involves work under the direct supervision of the faculty and is similar to the program outlined above. The associate instructorship, however, gives the graduate student the same responsibilities for the course being taught as any other faculty member. Interview with Prof. Sheldon Stryker, Chairman of the Department of Sociology, Indiana University, in Bloomington, Indiana, May 14, 1975.

[86] 56 T.C. 1350 (1971).

The court reasoned that if the university's objective had been to aid the faculty, part-time instructors could have been hired at a lesser cost.[87] The university withheld income taxes from the stipends and provided the teaching assistants with medical benefits maintained for employees and not available to other students, but these indications of an employment relationship were offset by the denial of other employee benefits to graduate assistants. Thus, the *Steiman* court established that teaching assistantship stipends are excludable scholarships when a university requires teaching services as part of its curriculum and treats its teaching assistants as students who are being trained.[88] This result is also possible, even if teaching is not absolutely required of all candidates for the degree, when an integrated program of teaching and research is required in a proportion determined by the faculty and the student to best fulfill the student's educational goals.[89]

When a scholarship exclusion is claimed for income tax purposes, it is advantageous to include supporting information with the tax return.[90] This documentation should consist of a letter from the student stating that he was enrolled as a graduate student at the particular university during the period involved and received a specific monetary stipend for teaching activity necessary for the degree. The letter also should state that this income is nontaxable under section 117 of the Internal Revenue Code of 1954 as interpreted in *Robert H. Steiman*, 56 T.C. 1350 (1971). A separate letter signed by the chairman of the department should also be included, stating the above information, and further stating that, as part of the training program, the student held an appointment as a graduate assistant for which the student received a specific monetary stipend from the university, that all graduate students are required to perform similar services as a condition to receiving the degree, that the teaching performed by the student as a graduate assistant is considered to be a valuable and integral part of his training, and that the teaching is not

[87] *Id.* at 1356.

[88] The Internal Revenue Service has acquiesced in the *Steiman* decision. 1971-2 CUM. BULL. 3.

[89] The Internal Revenue Service conducted audits of the income tax returns of several recipients of teaching assistantships in the Department of Psychology at Purdue University, which has this type of program. The exclusion of the teaching stipends from gross income was allowed as being substantially similar to *Steiman*.

[90] This procedure has been followed by graduate students in Psychology at Purdue University in successfully claiming scholarship exclusions of teaching assistantship stipends. This procedure is analogous to that which has been used successfully for more than ten years by students claiming the exclusion from gross income of research assistantships.

done for the benefit of any granting entity but is designed to contribute to the training of the student.

A grant differing substantially from that in *Steiman* generally is compensation. Failure to require teaching services of all degree candidates, for example, seems to foreclose conclusively the issue of excludability under section 117(b)(1), eliminating the necessity of a prior determination of whether the grant in fact qualifies as a scholarship.[91] In this situation, however, the Tax Court takes great pains to determine on the basis of other facts that the grant represents compensation and then closes its opinion by remarking that even if the record shows that teaching is required of all candidates, the exception is inapplicable absent an initial finding that the grant is a scholarship.[92]

In determining whether a teaching assistantship stipend is a scholarship, equivalency of services required of teaching assistants as a condition to receiving a stipend and services required of all degree candidates is of great significance. A stipend is an excludable scholarship when the only requirement, both for receiving the stipend and for receiving the degree, is to teach one course per quarter.[93] However, when the requirement for receiving the degree is to teach one course for one quarter, and the grant recipient teaches one course for each of three quarters, the stipend is compensation.[94] Thus, a teaching assistantship stipend is taxable compensation when the grant recipient performs different teaching activities, has different responsibilities, or is required to spend more time than degree candidates in general.

Failure to provide academic credit for teaching is also fatal to a showing that services are part of the curriculum or course of study and are not merely employment services.[95] Furthermore, an exclusion is denied when the substantive material taught by a grant recipient is only indirectly useful in the student's studies and any educational benefit gained from the teaching experience itself is merely incidental rather than the primary purpose of the teaching.[96]

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[91]Services required as a condition to receiving a grant are not regarded as part-time employment only if required of all degree candidates. INT. REV. CODE of 1954, § 117(b)(1). *See, e.g.*, Edward A. Jamieson, 51 T.C. 635 (1969); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061 (1968).

[92]Donald R. DiBona, 27 CCH Tax Ct. Mem. 1055, 1060 (1968); Rev. Rul. 73-368, 1973-2 CUM. BULL. 27.

[93]Logan v. United States, 73-2 U.S. Tax Cas. ¶ 9717 (N.D. Ohio 1973).

[94]Michael J. Larsen, 32 CCH Tax Ct. Mem. 1118 (1973).

[95]*Compare* Robert H. Steiman, 56 T.C. 1350 (1971) (excludable scholarship), *with* Allen J. Workman, 33 CCH Tax Ct. Mem. 16 (1974), *and* Edward A. Jamieson, 51 T.C. 635 (1969) (taxable compensation).

[96]Donald R. DiBona, 27 CCH Tax Ct. Mem. 1055, 1059 (1968); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061, 1065 (1968).

Two other indicia of whether the university considers teaching stipends as compensation rather than scholarships are given great weight. If a teaching assistant has full charge of his class, is responsible for giving course grades, and has the same degree of supervision as other teachers of similar experience, there is a presumption that the relationship between university and student is that of employer-employee.[97] If the number of assistantships granted is geared to the number of undergraduate students enrolled and, therefore, to the number of teachers needed, it is similarly indicative of an employment arrangement entered into for the benefit of the university.[98] Consequently, where teaching assistants replace additional staff who would be hired if no graduate students were available, teaching stipends are compensation, and any benefit to a grant recipient from the performance of these duties is considered incidental.[99] Two recent decisions holding teaching assistantship stipends to be compensation have been distinguished from *Steiman* on these grounds.[100]

In summary, teaching assistantship stipends paid to graduate students by the university in which the students are enrolled are scholarships excludable from gross income if the following conditions are satisfied: (1) equivalent teaching services are required of all degree candidates regardless of whether the students receive assistantships, (2) academic credit is given for the teaching performed, (3) the type of supervision of the student's activities indicates a learning experience, and the teaching duties assigned correspond to the student's field of interest and educational objectives, and (4) the teaching assistant does not have complete charge of the class and does not give grades, and the number of assistantships granted does not depend on the university's need for teachers.

The number of working hours required, the role of financial need in the selection of recipients, the amount of the stipend, the withholding of income tax from the stipend, and the receipt of fringe benefits are considered in determining whether the grant has the normal characteristics of a scholarship or is compensation

[97]Worthington v. Commissioner, 476 F.2d 589 (10th Cir. 1973), *aff'g* 31 CCH Tax Ct. Mem. 447 (1972) (even though teaching was required of all candidates for the degree); Edward A. Jamieson, 51 T.C. 635, 636 (1969); Elmer L. Reese, 45 T.C. 407, 411 (1966); Rev. Rul. 67-443, 1967-2 CUM. BULL. 75.

[98]*See, e.g.*, Worthington v. Commissioner, 476 F.2d 589 (10th Cir. 1973), *aff'g* 31 CCH Tax Ct. Mem. 447 (1972); Allen J. Workman, 33 CCH Tax Ct. Mem. 16 (1974); Edward A. Jamieson, 51 T.C. 635 (1969).

[99]Donald R. DiBona, 27 CCH Tax Ct. Mem. 1055, 1059 (1968); Kenneth J. Kopecky, 27 CCH Tax Ct. Mem. 1061, 1065 (1968).

[100]Worthington v. Commissioner, 476 F.2d 589 (10th Cir. 1973), *aff'g* 31 CCH Tax Ct. Mem. 447 (1972); Steinmetz v. United States, 343 F. Supp. 384 (N.D. Cal. 1972).

and are treated much the same as when a research assistantship is involved. These points are not conclusive proof of either scholarship or compensation, but are evidence of whether the university considers the graduate assistant to be a student or an employee. If the grant recipient has many characteristics in common with university employees, the stipend is likely to be compensation. Conversely, if the university treats the teaching assistant substantially the same as any other graduate student, the stipend is likely to be a scholarship.

C. University As Employer

In addition to graduate assistantships, universities traditionally offer programs which provide enrolled students with stipends for performing a variety of services with the university itself or with separate, off-campus organizations. Many of these programs are recognized by universities as part-time student employment, even if recipients are selected on the basis of financial need, duties imposed are related to the student's course of study, and payment is made from a special account. The work-study program sponsored by the Department of Health, Education and Welfare is an example of this part-time employment form of financial aid. Stipends paid under this work-study program represent compensation for services rendered, and no pretense is made that such payments are a scholarship.[101]

Stipends paid under other university programs such as the internships which are available in many fields of study, however, frequently are considered scholarships, although the factual circumstances parallel those of the work-study program. Unfortunately, the designation given the stipend by the grantor and the recipient is not as persuasive to the Internal Revenue Service and the courts as is the substance of the transaction. In determining whether internship grants are excludable, the Code provision which states that the exclusion does not apply to amounts received by a degree candidate as payment for services in the nature of part-time employment required as a condition to receiving the scholarship[102] is a formidable initial hurdle to surmount. Only three solutions to this problem are apparent: either the services are required of all degree candidates as a condition to receiving the degree, or the services are not in the nature of part-time employment, or the services are not required as a condition to receiving the scholarship. The applicability of these pos-

[101]UNITED STATES DEPARTMENT OF HEALTH, EDUCATION AND WELFARE, OFFICE OF EDUCATION, BUREAU OF HIGHER EDUCATION, COLLEGE WORK-STUDY PROGRAM MANUAL 7-7 (1968, revised April 1970).

[102]INT. REV. CODE of 1954, § 117(b)(1).

sible solutions is limited by the definitions given in the Treasury Regulations[103] of grants not considered scholarships, by the primary purpose test, and by the insistence that the grant possess the normal characteristics of a scholarship before the limitations on the exclusion, and the exceptions thereto, may even be considered.

The first proposed solution commonly is inapplicable to internship programs. Participation rarely is a prerequisite to receiving a degree, although many programs of the internship type which provide experience in areas related to the course of study offer academic credit to participants. Even when services are required of all degree candidates, classification of a stipend as a scholarship is not guaranteed when the circumstances as a whole indicate that recipients are paid to work rather than to study.[104]

The most generally applicable solution to the problem of nonexcludability of internship stipends is to show that the services are not in the nature of part-time employment. In making this determination, factors such as the benefit derived by the grantor, the primary purpose of the grant, and administrative practices must be considered. Very few cases, however, have been litigated in this area.[105] It cannot be determined whether this results from the recipients' having avoided audit of their tax returns or from a lack of confidence in the arguments favoring an exclusion.

Because students engaged in internship programs generally work with organizations outside their universities, these programs are suspected to have the primary purpose of benefiting the re-

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[103]Treas. Reg. § 1.117-4 (1956).

[104]Thus, where an institute of naval architecture required all students to satisfactorily complete a ten-week practical work term with a private employer, the stipend was considered to be compensation. Karl Laurence Kirkman, 29 CCH Tax Ct. Mem. 797 (1970).

Similarly, where participation in a ten-week work period each year was required by a university as a condition to receiving a Bachelor of Science degree, and the work performed was determined by the needs and activities of the employer, the stipend was compensation. Rev. Rul. 73-218, 1973-1 CUM. BULL. 53.

Also, where a theology school required all students to serve part-time in a parrish assignment which they had no choice in selecting, the stipend was compensation (and since the students were not ordained, they also were denied a rental allowance exclusion). Rev. Rul. 57-522, 1957-2 CUM. BULL. 50.

However, where a college as part of its philosophy of a complete education required all students to work part-time for the college, for which they received a nominal cash payment, the payment was a scholarship. Rev. Rul. 64-54, 1964-1 CUM. BULL. 81.

[105]Medical interns, of course, are notorious for litigating the character of their stipends. *See* discussion on pp. 780-88 *infra*. Such interns are not degree candidates, however, and the problems peculiar to the medical intern situation will be treated separately.

cipients of student services rather than being strictly educational in scope. The fact that these grants may come from yet a third source, that universities administer them, and that grant recipients receive academic credit are not indicia that students derive the primary benefit. Thus, Department of Health, Education and Welfare grants to students working at a center to improve educational services[106] and grants from a nonprofit organization to interns working for state legislators[107] have been found to be compensation for services rendered. Whether the original source of the grant and the beneficiary of the services are the same entity is immaterial. The term "grantor" extends to any entity in the administrative chain of the grant.[108] Therefore, if the services are performed under the direction of, or are in fact beneficial to, the organization receiving them, a stipend given for these services is considered compensation.

Stipends given to journalism students working with local newspaper staffs have been found to be compensation for services, although the interns did not replace employees who otherwise would have been hired.[109] The stipends were paid from a university "fellowship fund" to which the newspapers contributed. It was held that the use of a "fellowship fund" as a conduit for payment of the grants did not change the essential nature of the students' standing as employees during the training period, nor did it transform the payment into something other than compensation. From the employer's point of view the students filled the same role as any other part-time employee.

On the other hand, if a fellowship arrangement truly exists, its essential characteristics are not destroyed by treating the recipient as an employee only for payroll and bookkeeping purposes. For example, a grant paid to a postdoctoral research associate in education administration was considered a fellowship even though the recipient received full faculty privileges, the stipend was designated as a salary by the university, and payment was made under a Department of Health, Education and Welfare reimbursement contract which allocated no funds for fellowships.[110] Notably, no benefit was expected or received by

[106]Rev. Rul. 71-380, 1971-2 CUM. BULL. 101.

[107]Rev. Rul. 64-212, 1964-2 CUM. BULL. 39. *See* Rev. Rul. 71-559, 1971-2 CUM. BULL. 102 (the students worked with state legislative committees and the stipends were paid with a combination of state funds and contributions from a non-profit organization).

[108]Jerry S. Turem, 54 T.C. 1494, 1506-07 (1970); Marjorie E. Haley, 54 T.C. 642, 646 (1970).

[109]Rev. Rul. 64-213, 1964-2 CUM. BULL. 40.

[110]Louis C. Vaccaro, 58 T.C. 721 (1972). The Internal Revenue Service acquiesced in this decision. 1973-1 CUM. BULL. 2.

However, where the facts do not clearly show that the grantor receives

the university from the recipient's activities, which included coursework, reading, writing, and participating in a professional seminar. Also, the disbursement of a normal fellowship stipend was impossible under the contract requirements. Thus, use of earmarked salary funds by a university for an unauthorized purpose does not change the substance of a true fellowship arrangement.

In another situation, stipends received by medical technology students participating in a training program which required the performance of analyses in a hospital laboratory were considered excludable scholarships.[111] Students in the program were rotated within the laboratory as they became proficient in various techniques, and all student analyses were checked by registered technicians. This program obviously served only to train the students, and no benefit from the training activities inured to the hospital.

It is apparent from these decisions that the absence of a benefit to the grantor is the key to proving that services performed by student interns are not in the nature of part-time employment. A clear showing that the students' activities do not result in benefit to the grantor is necessary to remove from these grants the stigma of compensation for services rendered. The designation of compensation as a fellowship does not change the substance of an employment relationship. Conversely, the unauthorized use of salary funds does not work a transformation on a true fellowship arrangement.

Another possible solution to the nonexcludability of internship grants lies in a showing that the services are not required as a condition to receiving the grant. This solution generally is inapplicable to typical internship programs and, strictly speaking, is not a true solution at all. If no services are required, a

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no benefit from the recipient's activities, lack of authority to use the funds for fellowships indicates that the payments were made to further the grantor's function. Robert W. Carroll, 60 T.C. 96 (1973) (a college professor, who was principal investigator on a research project under a National Science Foundation grant, received a stipend for doing research during the summers). This conclusion is drawn more often in cases where the grantor is not a university. Harvey P. Utech, 55 T.C. 434 (1970) (research associate at the National Bureau of Standards under a National Academy of Science grant).

[111] Rev. Rul. 64-29, 1964-1 CUM. BULL. 79. *See* Rev. Rul. 72-568, 1972-2 CUM. BULL. 80 (student nurse stipends found to be scholarships). *But see* Rev. Rul. 73-89, 1973-1 CUM. BULL. 52 (where medical technologist trainees required to work one year in an approved hospital laboratory as a condition to receiving a degree, stipends found to be compensation since the work done was the same as that of any other hospital employee); Dennis Dale Brenneise, 33 CCH Tax Ct. Mem. 1 (1974); Rev. Rul. 74-474, 1974-2 CUM. BULL. 37 (stipends of pharmacy students working as hospital pharmacy residents were held to be compensation).

grant falls within the classical definition of a scholarship—a relatively disinterested payment to further the recipient's education and training in an individual capacity with no requirement of a quid pro quo.[112] Nevertheless, the absence of required services may explain why athletic grants-in-aid[113] are one type of university financial aid program whose character as a scholarship apparently has not been challenged. The lack of litigation in this area is surprising in light of the very strict view taken toward services performed for the grantor in other circumstances.

Typically, a recipient of an athletic grant-in-aid must sign a letter of intent to enroll at the grantor university and must try out for the sport involved.[114] Additionally, athletic departments frequently require athletes to perform odd jobs for the university. Universities admittedly would have to hire personnel to perform these services if students were not available.[115] Arguably, however, none of these requirements prevents a grant from qualifying as a scholarship. A letter of intent does not prohibit a student from enrolling at a different university[116] or from refusing to participate in athletics. Such conduct, of course, terminates a grant.[117] The same result is obtained, however, with respect to most university scholarships. Grants given by a university generally are limited to students enrolled at the university[118] and, in addition, frequently are further restricted to students in a particular curriculum.[119] These qualifications placed upon a recipient do not detract from a grant's characterization as a scholarship.

Students who participate in a sport and perform odd jobs for the university admittedly render services for the grantor.

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[112]Bingler v. Johnson, 394 U.S. 741, 751 (1969).

[113]Grants-in-aid are distinguished from scholarships by the lack of a high academic grade requirement for eligibility. INDIANA UNIVERSITY, INDIANA UNIVERSITY BULLETIN, FINANCIAL AIDS FOR STUDENTS 8, 13 (1971) [hereinafter cited as FINANCIAL AIDS BULLETIN]. Both grants-in-aid and scholarships are considered to be "gift aid." *Id.* at 6-7.

[114]Interview with William Sylvester, Athletic Director, Butler University, in Indianapolis, May 8, 1975.

[115]Typical jobs are cleaning up the stadium or field house after games, ushering at games, acting as equipment manager or student trainer, or assisting with physical education classes. *Id.*

[116]In some instances failure to enroll results in a loss of eligibility for financial aid and athletic competition if the athlete enrolls at another university. This depends on the agreement between the schools. *Id.*

[117]Rule 3-1-(f)(2), NATIONAL COLLEGIATE ATHLETIC ASSOCIATION, 1975-1976 NCAA MANUAL 8 [hereinafter cited as NCAA MANUAL].

[118]FINANCIAL AIDS BULLETIN, *supra* note 113, at 8-10.

[119]Scholarships are available to students enrolled in every subject from art to zoology. Indeed, one scholarship is available which gives preference to members of the auditorium usher corps. *Id.* at 31-82.

Neither of these activities, however, is necessarily required as a condition to receiving the grant.[120] An athletic grant-in-aid may not be terminated or reduced because a recipient lacks athletic ability, fails to contribute to his team's success, cannot participate because of injury, or refuses to perform assigned tasks.[121] Specifically, these grants may be terminated only if a recipient fails to satisfy the university's academic requirements, voluntarily renders himself ineligible for athletic competition, fraudulently misrepresents information on a grant-in-aid application, or subjects himself to substantial disciplinary action by the university.[122] Similar grounds for termination are common to most university academic scholarships.[123]

The maximum permissible financial aid to athletes may not exceed the "commonly accepted educational expenses," which are defined as tuition, fees, room, board, and book expenses.[124] All amounts received by a student during a school term from athletic grants-in-aid, other scholarships, employment, and similar sources must not exceed this limitation and must be administered by the university.[125] Thus, both the amount and the granting entity are restricted, and the grants bear no relation to compensation which would be paid for similar services in an employer-employee relationship. Furthermore, athletic grants are awarded by a university scholarship committee upon recommendation of the ath-

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[120]It should be remembered, however, that grants have been determined to be compensation when future services were not actually required, but only *expected*, of the recipient. *See, e.g.*, Reiffen v. United States, 376 F.2d 883 (Ct. Cl. 1967); John E. MacDonald, Jr., 52 T.C. 386 (1969).

[121]The period for which the grant may be given varies among schools from one semester to four years. Renewal is, of course, optional. In practice, however, renewal of a grant is not denied because an athlete is injured and does not play. Interview with William Sylvester, Athletic Director, Butler University, in Indianapolis, May 8, 1975.

[122]Rule 3-1-(f), NCAA MANUAL, *supra* note 117, at 8.

[123]It is specifically provided that any disciplinary action taken toward the recipient of an athletic grant-in-aid must be based on institutional policy applicable to the general student body. *Id.*

University disciplinary action toward a recipient of a university academic scholarship, particularly if such action involves suspension from classes, is ground for terminating the scholarship. Interview with Dr. Doris Merritt, Dean for Sponsored Programs, Indiana University-Purdue University at Indianapolis, and Associate Dean for Research and Advanced Studies, Indiana University, in Indianapolis, May 5, 1975.

[124]Rule 3-1-(f), NCAA MANUAL, *supra* note 117, at 8. Fifteen dollars per month for incidental expenses is also allowed, but few schools grant this amount. Interview with William Sylvester, Athletic Director, Butler University, in Indianapolis, May 8, 1975.

[125]Rule 3-4, NCAA MANUAL, *supra* note 117, at 13. An exception is made for military service benefits and assistance from those upon whom the student is naturally or legally dependent. *Id.*

letic department. This is the same administrative procedure used in awarding other departmental scholarships.[126]

In spite of these arguments, athletic grants-in-aid seem closely related to many other grants which are held to be compensation.[127] The favorable treatment accorded athletic scholarships probably represents a policy decision that such grants should be excluded from gross income and that the national interest in encouraging continued education should prevail, if the grant is limited by and closely related to normal educational expenses.[128]

In summary, stipends paid by a university to its students under internship and work-study programs which are not required as a condition to receiving the degree generally are compensation for services rendered. These grants fall into the category of excludable scholarships only if (1) no benefit from the student's activities inures to the grantor, (2) academic credit is given for the services performed, and (3) the type of supervision of students indicates a learning experience, and the duties assigned correspond to the student's field of interest and educational objectives. The number of working hours required, the role of financial need in selecting the grant recipients, the amount of the stipend, the withholding of income tax from the stipend, and the account from which the grant is paid are considered in determining whether the grant is a scholarship or is compensation, but are not conclusive proof of either result.

III. Medical Interns and Residents

A. Non-Degree Candidates

The continuing struggle of medical interns and residents[129] to gain income tax exempt status for stipends paid by hospitals

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[126]*See, e.g.*, Financial Aids Bulletin, *supra* note 113, at 31-82.

[127]A different result was indeed reached when a grant encompassing most of the characteristics of an athletic grant-in-aid, *i.e.*, payment of tuition, fees, room, board, and books, which was not terminated by the unconditional release of the player, but only by his voluntary failure to report for training or to attend an accredited college, was given by a professional ball club to a player under contract to them. Such payments were held to be part of the bargained-for compensation paid under the contract. Rev. Rul. 69-424, 1969-2 Cum. Bull. 15.

[128]In several cases involving grants from employers, only the stipend was questioned, and payments of tuition and fees were not at issue. Bingler v. Johnson, 394 U.S. 741 (1969); Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961); Jerry S. Turem, 54 T.C. 1494 (1970); John E. MacDonald, Jr., 52 T.C. 386 (1969).

[129]Because senior medical students receive substantial clinical experience, the American Medical Association has abolished the term "intern" effective

which train physicians presents an interesting example of an exercise in futility. This controversy has been litigated at least fifty-three times since 1958,[130] and the taxpayer has been successful in only five cases.[131]

July 1, 1975. Henceforth all postgraduate clinical training will be termed a residency. Interview with Dr. A. David McKinley, Assistant Dean of Medicine, Indiana University School of Medicine, in Indianapolis, May 8, 1975.

[130]Birnbaum v. Commissioner, 73-1 U.S. Tax Cas. ¶ 9378 (3d Cir. 1973), *aff'g* 30 CCH Tax Ct. Mem. 989 (1971); Parr v. United States, 469 F.2d 1156 (5th Cir. 1972); Hembree v. United States, 72-2 U.S. Tax Cas. ¶ 9607 (4th Cir. 1972), *rev'g* 71-2 U.S. Tax Cas. ¶ 9636 (D.S.C. 1971); Rundell v. Commissioner, 72-1 U.S. Tax Cas. ¶ 9277 (5th Cir. 1972), *aff'g* 30 CCH Tax Ct. Mem. 177 (1971); Woddail v. Commissioner, 321 F.2d 721 (10th Cir. 1963); Biggs v. United States, 73-1 U.S. Tax Cas. ¶ 9267 (E.D. Ky. 1972); Tobin v. United States, 323 F. Supp. 239 (S.D. Tex. 1971); Wertzberger v. United States, 315 F. Supp. 34 (W.D. Mo. 1970); Coggins v. United States, 70-2 U.S. Tax Cas. ¶ 9687 (N.D. Tex. 1970); Kwass v. United States, 70-2 U.S. Tax Cas. ¶ 9615 (E.D. Mich. 1970); Taylor v. United States, 68-2 U.S. Tax Cas. ¶ 9488 (E.D. Ark. 1968); Lingl v. Charles, 68-1 U.S. Tax Cas. ¶ 9153 (S.D. Ohio 1967); Sheldon A. E. Rosenthal, 63 T.C. No. 40 (1975); Geral W. Dietz, 62 T.C. 578 (1974); Walter L. Peterson, 33 CCH Tax Ct. Mem. 1367 (1974); Byron L. Howard, Jr., 33 CCH Tax Ct. Mem. 869 (1974); Donald D. Fagelman, 33 CCH Tax Ct. Mem. 864 (1974); Thomas A. Woods, 33 CCH Tax Ct. Mem. 861 (1974); Wesley E. McEntire, 33 CCH Tax Ct. Mem. 780 (1974); George A. Fisher, 33 CCH Tax Ct. Mem. 771 (1974); Douglas R. Jacobson, 33 CCH Tax Ct. Mem. 762 (1974); R. M. Nugent, Jr., 33 CCH Tax Ct. Mem. 690 (1974); Carl H. Naman, 33 CCH Tax Ct. Mem. 681 (1974); George M. Towns, 33 CCH Tax Ct. Mem. 632 (1974); John E. Hamacher, 33 CCH Tax Ct. Mem. 529 (1974); George Weissfisch, 33 CCH Tax Ct. Mem. 391 (1974); Marvin L. Dietrich, 33 CCH Tax Ct. Mem. 66 (1974); Paul R. Zehnder, 32 CCH Tax Ct. Mem. 1189 (1973); Enrique Kaufman, 32 CCH Tax Ct. Mem. 525 (1973); Esfandiar Kadivar, 32 CCH Tax Ct. Mem. 427 (1973); Richard F. Bergeron, 31 CCH Tax Ct. Mem. 1226 (1972); Bayard L. Moffit, 31 CCH Tax Ct. Mem. 910 (1972); Larry R. Taylor, 31 CCH Tax Ct. Mem. 57 (1972); Jacob T. Moll, 57 T.C. 579 (1972); Arthur Calick, 31 CCH Tax Ct. Mem. 69 (1972); Frederick Fisher, 56 T.C. 1201 (1971); Ernest Griffin Moore, Jr., 30 CCH Tax Ct. Mem. 1347 (1971); Dee L. Fuller, 30 CCH Tax Ct. Mem. 1116 (1971); Irwin S. Anderson, 54 T.C. 1547 (1970); Janis Dimants, Jr., 29 CCH Tax Ct. Mem. 1138 (1970); Marvin Flicker, 29 CCH Tax Ct. Mem. 1115 (1970); Edward A. Ballerini, 29 CCH Tax Ct. Mem. 1595 (1970); Austin M. Katz, 29 CCH Tax Ct. Mem. 511 (1970); Aloysius J. Proskey, 51 T.C. 918 (1969); Oscar A. Arnaud, 27 CCH Tax Ct. Mem. 1541 (1968); Ethel M. Bonn, 34 T.C. 64 (1960).

In addition, one physician twice litigated the tax status of his residency stipend, the amounts at issue being received during different years, and lost both times. Emerson Emory, 32 CCH Tax Ct. Mem. 245 (1973); 30 CCH Tax Ct. Mem. 785 (1971).

In addition to this multitude of cases, several Revenue Rulings also reach the same conclusion. Rev. Rul. 71-346, 1971-2 CUM. BULL. 99; Rev. Rul. 68-520, 1968-2 CUM. BULL. 58; Rev. Rul. 57-386, 1957-2 CUM. BULL. 107.

[131]Leathers v. United States, 471 F.2d 856 (8th Cir. 1972), *aff'g* 71-2 U.S. Tax Cas. ¶ 9573 (E.D. Ark. 1971); Pappas v. United States, 67-1 U.S.

Medical residencies are the epitome of "learning by doing" educational training. Residents receive training while associated with, and performing services for, one or more hospitals.[132] Many programs involve rotation among several hospitals in order to provide experience in treating a varied patient population and a broad spectrum of medical problems.[133] The resident is considered to be his patients' primary physician and is responsible for taking admitting histories, giving physical examinations, ordering lab work, and providing emergency and continuing care.

A senior resident has direct responsibility for patient care, supervises the activities of junior residents, and participates in teaching courses to medical students. Increasing responsibilities and opportunities are given as a resident's experience increases. The ultimate responsibility for patients' treatment and supervision of the residents, however, rests with the permanent hospital staff. Residency programs place heavy emphasis on clinical work through ward rounds, formal classes and seminars, and informal discussions with the staff physicians. Nonetheless, patient responsibility is considered the only training which will fully develop a resident's medical knowledge, skills, and judgment.

Each medical specialty department determines the number of residencies it will offer. This determination is based upon the facilities and staff available to implement the training, the number of hospital beds, the need for personnel, and the money available for stipends.[134] These stipends, which provide $10,500 to $15,000, are paid by the hospital with which the resident is asso-

Tax Cas. ¶ 9386 (E.D. Ark. 1967); Wrobleski v. Bingler, 161 F. Supp. 901 (W.D. Pa. 1958); George L. Bailey, 60 T.C. 447 (1973); Frederick A. Bieberdorf, 60 T.C. 114 (1973).

[132]The typical program outlined here is based on the program offered by the Indiana University Hospitals, Indianapolis, Indiana. INDIANA UNIVERSITY, SCHOOL OF MEDICINE, INTERNSHIP AND RESIDENCY PROGRAMS. Descriptions of the typical fact situation also are found in the following cases: Woddail v. Commissioner, 321 F.2d 721 (10th Cir. 1963); Aloysius J. Proskey, 51 T.C. 918 (1969); Ethel M. Bonn, 34 T.C. 64 (1960).

Interns and residents are not considered to be degree candidates. Tobin v. United States, 323 F. Supp. 239, 241 (S.D. Tex. 1971); Wertzberger v. United States, 315 F. Supp. 34, 35 (W.D. Mo. 1970); Wrobleski v. Bingler, 161 F. Supp. 901, 903 (W.D. Pa. 1958); Rev. Rul. 72-70, 1972-1 CUM. BULL. 39.

[133]Residents at Indiana University Medical Center rotate among the University Hospitals (established as teaching and referral hospitals), Marion County General Hospital, and the Veterans Administration Hospital. INDIANA UNIVERSITY SCHOOL OF MEDICINE, INTERNSHIP AND RESIDENCY PROGRAM.

[134]The American Medical Association must approve the number of residencies offered by each hospital. The number of residencies is reduced if the hospital does not have sufficient permanent staff and facilities to effectively train the residents. Interview with Dr. A. David McKinley, Assistant Dean of Medicine, Indiana University School of Medicine, in Indianapolis, May 8, 1975.

ciated. If a particular program involves duties at several hospitals in rotation, the resident is paid by each hospital during the period of association. Fringe benefits such as medical care, insurance, vacation, and laundry services normally are received under these programs. A hospital generally considers residents to be employees. It designates stipends as salaries and withholds income tax.[135]

Stipends received by residents consistently are treated as compensation for services rendered when the principal function of the hospital is to provide patient care and the residents perform duties of necessary personnel who otherwise would be hired. Decisions in this area are based upon the premise that residency programs are designed to facilitate the primary purpose of the hospital—the care and treatment of patients.[136] The services performed by residents are characterized as valuable, essential, professional, and substantial in terms of both time spent and importance to the hospital.[137] The activities are geared to the hospital's operational needs, and any training provided is incidental to the primary objective of providing treatment for the patients.[138]

While it is true that residents do not have complete responsibility for patients and are supervised by permanent staff, it is also true that most employees are subject to some degree of supervision.[139] Stipends paid to residents, therefore, are not fellowships because the grants are paid to enable the recipients to pursue studies primarily for the benefit of and subject to the direction of the grantor.[140] It is irrelevant whether the initial grantor is a hospital or another organization. If funds are channeled through a hospital that receives a benefit from services, the stipend is regarded as compensation for those services.[141]

A stipend is not transformed into a fellowship because the

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[135] *Id.*

[136] *See, e.g.*, Woddail v. Commissioner, 321 F.2d 721 (10th Cir. 1963); Aloysius J. Proskey, 51 T.C. 918 (1969).

[137] Ethel M. Bonn, 34 T.C. 64, 70 (1960).

[138] *Id.* at 73; Aloysius J. Proskey, 51 T.C. 918, 923 (1969); Rev. Rul. 71-346, 1971-2 CUM. BULL. 99.

[139] Tobin v. United States, 323 F. Supp. 239, 241 (S.D. Tex. 1971).

[140] Treas. Reg. § 1.117-4(c)(1), (2) (1956).

[141] Emerson Emory, 30 CCH Tax Ct. Mem. 785, 787 (1971). *See* Ulak v. United States, 1972-1 U.S. Tax Cas. ¶ 9468 (S.D. Cal. 1972); Jerry S. Turem, 54 T.C. 1494 (1970); Marjorie E. Haley, 54 T.C. 642 (1970).

Where the physician is both a resident and a participant in a training program which is the same whether or not the resident receives a stipend, even payment of the training grant and the residency stipend from separate funds does not negate the fact that beneficial services are performed for such payment. Rev. Rul. 71-346, 1971-2 CUM. BULL. 99.

recipient derives substantial benefit from his training.[142] In applying the primary purpose test, the recipient's motive in accepting the grant is immaterial; only the grantor's motive is significant.[143] Since the recipient's purpose always is to further his training, this seems to be the proper approach.

> [V]irtually all work as an apprentice, whether in medicine or law, or carpentry or masonry, provides valuable training. Nothing in section 117 requires that an amount paid as compensation for services rendered be treated as a nontaxable fellowship grant, merely because the recipient is learning a trade, business, or profession.[144]

In fact, a more perfect employer-employee relationship than that which exists between hospital and resident would be difficult to imagine.[145]

Absence of benefit to the hospital from the resident's activities is the distinguishing feature of the rare residency stipend which qualifies as a fellowship. In *Frederick A. Bieberdorf,*[146] a resident spent twenty-five percent of his time in clinical work and seventy-five percent doing research. His clinical activities consisted of examining patients at a hospital in consultation with the hospital staff, attending seminars, and learning techniques. He did not treat patients on his own initiative,[147] and his major commitment was research, which was performed under the direction and close supervision of a medical school faculty. Initially, he worked on established research projects, and later, as he developed independent interests and ideas, he began an original project. The patients on whom the research was performed were referred to the medical school for study and were not regular patients of the hospital.

The medical school paid the stipend from a National Institutes of Health grant, and income tax was withheld. Furthermore, the medical school paid for insurance, although in a lesser amount than for faculty members. In sum, the resident had no responsibility for patient care, did not replace hospital staff, and had no duty to render services to the hospital. The services that the resident did perform were merely incidental to the training

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[142]Kwass v. United States, 1970-2 U.S. Tax Cas. ¶ 9615, at 84,526 (E.D. Mich. 1970); Dee L. Fuller, 30 CCH Tax Ct. Mem. 1116, 1118 (1971).

[143]Emerson Emory, 30 CCH Tax Ct. Mem. 785, 787 (1971).

[144]Aloysius J. Proskey, 51 T.C. 918, 925 (1969).

[145]Woddail v. Commissioner, 321 F.2d 721, 724 (10th Cir. 1963).

[146]60 T.C. 114 (1973).

[147]Similarly, where the clinical activities of the resident were limited to transfering the observations and directions of the senior staff onto the patients' charts, and to making suggestions during rounds, the activities were found to be of minimal value to the hospital and the stipend received by the resident was a fellowship. George L. Bailey, 60 T.C. 447 (1973).

program and of minimal benefit to the hospital. Although the administration of the stipend had some of the characteristics of an employment relationship, the hospital did not benefit from the resident's activities. The stipend, therefore, was a fellowship.

Another situation in which a residency stipend is a scholarship is when a hospital's purpose is to teach residents rather than treat patients. In *Wrobleski v. Bingler*,[148] the court found that a hospital was designed primarily as a center for research and for the education and development of qualified specialists. To provide a cross-section of cases necessary for training, the patients admitted to the hospital were selected from persons hospitalized elsewhere. Since the institute had adequate staff, the services performed by residents were only supplementary. Moreover, the services were not of material benefit since they were performed under continuous, individual supervision. For these reasons, the court concluded that the stipend was a fellowship. Once the primary purpose test is satisfied, therefore, the fact that a grantor derives incidental benefit from activities of the grant recipient does not affect the excludability of the grant from gross income.[149]

The two other cases in which grants to residents were found to be fellowships were decided by juries.[150] These decisions were based upon determinations that the payments were primarily intended to further the education of the recipient in an individual capacity and did not represent compensation for services. The specific facts and reasoning underlying the decisions, however, were not reported.[151]

Similar considerations also are applied to non-medical internships. Amounts paid to ministerial interns and residents in a program of training in pastoral care,[152] or to social service interns training with a social service agency,[153] have been deemed compensation when the recipients were primarily performing services but also were acquiring training. On the other hand, the

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[148]161 F. Supp. 901, 905 (W.D. Pa. 1958).

[149]*Id.* at 904.

[150]Leathers v. United States, 471 F.2d 856 (8th Cir. 1972), *aff'g* 71-2 U.S. Tax Cas. ¶ 9573 (E.D. Ark. 1971); Pappas v. United States, 67-1 U.S. Tax Cas. ¶ 9386 (E.D. Ark. 1967).

[151]Oscar A. Arnaud, 27 CCH Tax Ct. Mem. 1541, 1543 (1968).

In most of the subsequent cases, the court preferred to distinguish *Pappas* on the ground that the stipend paid to Dr. Pappas was primarily to further the recipient's education and training, and the present facts do not support such a determination. *See, e.g.*, Rundell v. Commissioner, 72-1 U.S. Tax Cas. ¶ 9277 (5th Cir. 1972), *aff'g* 30 CCH Tax Ct. Mem. 177 (1971); Arthur Calick, 31 CCH Tax Ct. Mem. 69 (1972).

[152]Rev. Rul. 70-648, 1970-2 CUM. BULL. 21.

[153]Rev. Rul. 66-83, 1966-1 CUM. BULL. 30.

stipend of a dietetic intern who did not stay at any one institution long enough to perform significant, beneficial services was found to be a scholarship.[154] The stipends of pastoral trainees at a teaching hospital which selected patients to meet the needs of the teaching program and had a permanent staff sufficient to serve the patients' needs also were scholarships.[155]

The credibility of basing a stipend exclusion upon the functional purpose of the grantor hospital recently has been diminished. The district court in *Hembree v. United States*[156] had held that the stipend received by a resident from a university hospital, which had been established specifically as a teaching hospital, was a scholarship. The court of appeals reversed this decision, however, and concluded that the primary purpose of the hospital was not a proper criterion for determining the character of the resident's stipend. The primary purpose of the payment to the resident, rather than the use of the facility, was controlling.[157] Thus, the primary purpose test, as applied to residency stipends, has undergone a subtle shift in focus which makes it even more unlikely that the stipends can qualify as fellowships. The primary function of the hospital as an exclusively teaching institution is no longer sufficient to support a claim that a stipend is a relatively disinterested educational grant with no requirement of a substantial quid pro quo.

The exclusion of many stipends apparently goes unchallenged[158] because of policy differences among local Internal Revenue Service offices.[159] For this reason, residents whose exclusion is challenged have not been reluctant to litigate the matter. This divergence between the results of litigated cases and the actual

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[154]Thomas P. Phillips, 57 T.C. 420 (1971).

[155]Rev. Rul. 74-186, 1974-1 CUM. BULL. 37. Rev. Rul. 70-648, 1970-2 CUM. BULL. 21, is distinguished.

[156]72-2 U.S. Tax Cas. ¶ 9607 (4th Cir. 1972), *rev'g* 71-2 U.S. Tax Cas. ¶ 9636 (D.S.C. 1971). The residency program involved rotation among the university hospital, a county hospital, and a Veterans Administration hospital. The district court held that the portion of the stipend received by the resident while working at the university hospital was an excludable scholarship, while the stipends received from the county and Veterans Administration hospitals were compensation for services.

[157]72-2 U.S. Tax Cas. ¶ 9607, at 85,441.

[158]The results of a survey taken by a medical journal show that out of 887 residents polled, 29% claimed the exclusion; and out of 116 physicians on fellowships, 55% claimed the exclusion. Of the exclusions claimed, 91% of those by residents and 96% of those by fellows went unchallenged. On the returns which were audited, some exclusions were disallowed and some were not even questioned. *Another Look at That $3600 Fellowship Exclusion*, HOSPITAL PHYSICIAN 42 (July 1971).

[159]Jacobson & deRham, *Lawyer and Accountant Clash on $3600 Exclusion*, RESIDENT & STAFF PHYSICIAN 99 (Nov. 1971).

treatment of a significant percentage of the nonlitigated residency stipends has caused a similar divergence of opinion regarding the proper course for a resident to follow. If a resident can state with confidence that his hospital considers the primary purpose of the residency program to be the furtherance of the resident's education rather than service to patients, it has been suggested that the exclusion should be claimed.[160] Emphatic disagreement with this position, however, has been expressed on the ground that one so advising a resident is participating in a plan for improper avoidance of income tax.[161] The latter position seems untenable, however, since the Internal Revenue Service, in answer to a request for a ruling, has stated that no formal determination can be made.[162] Each case must be decided upon its own facts and circumstances. Nevertheless, it should be emphasized that a resident claiming an exclusion must believe that his hospital considers the primary purpose of its program, including the payment of the stipend, to be strictly educational. It is a rare hospital that can meet this criterion.

In summary, stipends paid to residents by a hospital in which they are training are taxable compensation. Only in the extremely rare case of a stipend paid solely to enable the recipient to pursue his education and training, with no significant benefit from the recipient's activities inuring to the grantor, is a residency stipend a fellowship and excludable from gross income.

B. Degree Candidates

Occasionally a physician serving a residency does so in the capacity of a degree candidate.[163] In this situation, the determination of the character of a stipend is governed by precedent established in cases involving graduate assistantships as well as in cases involving the more common types of medical residencies.[164] Therefore, if a training program is under the supervision of a graduate school and is part of the regular curriculum required of all degree candidates, a stipend qualifies as a fellowship grant.[165] Similarly, if a program is not directly controlled by a graduate school, but a resident's activities are part of the degree requirements and are limited to strictly observational and

[160]Jacobson, *Tax Tips for Hospital Doctors*, RESIDENT & STAFF PHYSICIAN 91 (Jan. 1971).

[161]Jacobson & deRham, *Lawyer and Accountant Clash on $3600 Exclusion*, RESIDENT & STAFF PHYSICIAN 99 (Nov. 1971).

[162]*Id.*

[163]*E.g.*, Master of Science in Internal Medicine, Doctor of Philosophy in Clinical Psychology, or Master of Science in Hospital Administration.

[164]William Wells, 40 T.C. 40, 47 (1963).

[165]Anderson v. United States, 61-1 U.S. Tax Cas. ¶ 9162 (D. Minn. 1960).

educational functions, the grant is a fellowship if the resident does not replace any of the institution's personnel.[166] Even if the resident functions as part of the work force providing patient care at a hospital whose primary purpose is treating patients, if the resident's services are closely supervised and of limited value to the hospital and there is no reduction in the number of regular employees, the stipend still is considered a fellowship.[167]

A residency combined with a degree program is distinguishable from the typical medical residency only on the ground that the grant recipient is a candidate for a degree. This characteristic, of course, also links such a residency to the graduate assistantships given by universities. Thus, the determination of whether a grant to a resident degree candidate has the normal characteristics of a fellowship hinges on criteria drawn from both areas, for example, the granting of academic credit and the degree of supervision of the recipient, coupled with a strict interpretation of the type of services which constitute benefit to the grantor.[168]

In summary, stipends paid to resident degree candidates by hospitals in which they are training constitute compensation for services rendered. The stipends are classified as fellowships only if (1) the payments meet the requirements for this determination with respect to a normal medical residency, *i.e.*, no benefit inures to the grantor, or (2) the payments meet the requirements for such a determination with respect to a graduate assistantship, *i.e.*, the activities are part of the regular curriculum required of all degree candidates, and academic credit is given.

IV. Employer As Grantor

A. Degree Candidates

Many companies have programs for supporting higher education in which funds are granted to universities or to individual recipients. The most common of these programs are scholarship

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[166]Shuff v. United States, 331 F. Supp. 807 (W.D. Va. 1971).

[167]Paul H. Chesmore, 33 CCH Tax Ct. Mem. 1226 (1974); William Wells, 40 T.C. 40 (1963).

[168] The Internal Revenue Service acquiesced in the decisions in William Wells, 40 T.C. 40 (1963), and Anderson v. United States, 61-1 U.S. Tax Cas. ¶ 9162 (D. Minn. 1960), and this acquiescence has not been removed. Rev. Rul. 65-59, 1965-1 Cum. Bull. 67. However, subsequent cases generally were distinguished on their facts and similar stipends held to be compensation. *See, e.g.*, Quast v. United States, 428 F.2d 750, 754 (8th Cir. 1970) (merely receiving academic credit for residency work does not necessarily make a stipend a fellowship); John M. Gullo, 30 CCH Tax Ct. Mem. 1434 (1971).

and fellowship grants[169] and employee tuition-aid plans.[170] Fellowship plans generally provide funds to full-time students in a specified field.[171] Their broad purpose is encouraging students to prepare for careers in areas related to the company's business. The company benefits from the additional manpower available for recruitment while fulfilling its sense of social responsibility and enhancing its public image.[172]

Grants made under many of these plans fit the classical description of scholarships and fellowships. The funds are paid through a university, which selects the recipients on the basis of scholarship and financial need. Companies, however, often retain the right of final approval of the university's selection.[173] The area of study in which the recipient must engage frequently is specified by the company, but no other control over the recipient's research or course of study is exercised.[174] Furthermore, these grants are not conditioned upon acceptance of post-graduate employment with the grantor.[175] Under these circumstances, the funds are not compensation for past, present, or future services. Any benefit ultimately derived by the company is merely incidental to furthering the recipient's education. The amounts received, therefore, are excludable from gross income as a scholarship.

Different considerations predominate when grants are made to employees of the grantor company. The major objective then is to update employees' technical knowledge and prepare them for positions of higher responsibility.[176] Although grant recipients devote full time to studies and the company requires no services

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[169]A comprehensive study has been made of corporate fellowship plans. This report covers 75 plans sponsored by 60 companies. NATIONAL INDUSTRIAL CONFERENCE BOARD, INC., 209 STUDIES IN PERSONNEL POLICY. COMBATTING KNOWLEDGE OBSOLESCENCE: I. COMPANY FELLOWSHIP PLANS (1968) [hereinafter cited as Fellowship Report].

[170]A similar study also has been made of corporate tuition-aid plans. This report covers 200 plans by as many companies. NATIONAL INDUSTRIAL CONFERENCE BOARD, INC., 221 STUDIES IN PERSONNEL POLICY. COMBATTING KNOWLEDGE OBSOLESCENCE: II. EMPLOYEE TUITION-AID PLANS (1970) [hereinafter cited as Tuition-Aid Report].

[171]Fellowship Report, *supra* note 169, at 24.

[172]The stated objectives in order of frequency of occurrence are: to enlarge the supply of scientific specialists for recruitment, to support the national scientific effort, to interest universities in the company's research projects, to fulfill the corporate sense of social responsibility, to enhance the company's image, to bring employees up to date on new developments, and to prepare employees for more responsible positions. *Id.* at 23.

[173]*Id.* at 65, 69.

[174]*Id.* at 27.

[175]*Id.* at 61.

[176]*Id.* at 23.

during the grant period, the company generally regards these employees as being on either a special work assignment or an educational leave of absence. In these circumstances, courts do not hesitate to find a continuing employment relationship. Requiring a recipient to work for the grantor for a specified period following the completion of his educational training also supports a determination that a grant is compensation.[177] Few grant recipients subject to an obligation of this nature are successful in claiming a scholarship exclusion for income tax purposes.

Aileene Evans[178] represents a successful assertion that an educational grant from an employer was a scholarship, even though future employment was required of the recipient. *Evans* frequently has been relied upon by taxpayers, and just as frequently has been distinguished on the ground that Ms. Evans had not been employed by the grantor prior to receiving the grant.[179] After many years of being distinguished into nonexistence, *Evans* finally was declared an unsound precedent,[180] and the Internal Revenue Service removed its acquiescence.[181] It is now clear that a stipend given to enable the recipient to pursue further training and in consideration of a promise of future employment is taxable compensation.[182]

Even when no obligation of future employment exists, circumstances often show that a grant is given with the expectation that the employment relationship will continue. This expectation is a sufficient ground for reaching the conclusion that a grant is

[177] *Id.* at 49. Many of the cases involved employees of state welfare agencies who took advantage of educational leave programs funded jointly by the federal government and the states. These programs generally required employment following receipt of the academic degree for a period equal to the leave time. Ulak v. United States, 1972-1 U.S. Tax Cas. ¶ 9468 (S.D. Cal. 1972); Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961); H. Norman Brown, 31 CCH Tax Ct. Mem. 457 (1972); Norman F. Stougaard, 30 CCH Tax Ct. Mem. 1331 (1971); Lowell D. Ward, 55 T.C. 308 (1970); Jerry S. Turem, 54 T.C. 1494 (1970); Marjorie E. Haley, 54 T.C. 642 (1970); Aileene Evans, 34 T.C. 720 (1960).

Most corporate fellowship programs do not require future employment. However, employees are encouraged to continue their employment. Fellowship Report, *supra* note 169, at 61-62.

[178] 34 T.C. 720 (1960). The Internal Revenue Service acquiesced in this decision. Rev. Rul. 65-146, 1965-1 CUM. BULL. 66.

[179] *See, e.g.*, Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Jerry S. Turem, 54 T.C. 1494 (1970).

[180] Lowell D. Ward, 55 T.C. 308, 311 (1970).

[181] Rev. Rul. 70-283, 1970-1 CUM. BULL. 26.

[182] *See, e.g.*, H. Norman Brown, 31 CCH Tax Ct. Mem. 457 (1972); Eugene W. Helms, 31 CCH Tax Ct. Mem. 442 (1972); James G. Harper, 31 CCH Tax Ct. Mem. 424 (1972); Leonard T. Fielding, 57 T.C. 761 (1972); Robert H. Kyle, 31 CCH Tax Ct. Mem. 327 (1972).

given primarily for the benefit of the grantor.[183] The mere absence of a contract to perform services does not make a stipend a scholarship if the evidence as a whole suggests otherwise.[184]

Incongruously, payment of tuition, room, board, books, and a small monthly stipend by the Department of the Navy to Naval R.O.T.C. students has been held to be a scholarship despite a requirement of future services to the grantor.[185] The recipient was found to be acquiring a basic college education and not training specifically for naval duties. To determine the primary purpose of the grant, the court looked to the immediate purpose of furthering the student's education and avoided the ultimate motive of aiding the officer procurement program. It was further suggested that the determinative consideration was not the principal purpose of the grantor in subsidizing the student but the principal purpose of the benefit from the study.[186] This proposal, however, has not gained acceptance in subsequent cases.[187]

In cases of employee grants, great weight is given to the view which the grantor takes of the recipient and the grant program. Occasionally this view is explicitly stated, as when the grantor's brochure refers to the recipient as continuing in the capacity of an employee[188] or as being on special work assignment.[189] More often, a grantor's outlook is inferred from other details of the relationship. For example, an employee frequently is regarded as taking an educational leave of absence.[190] Accord-

[183]*See, e.g.*, Reiffen v. United States, 376 F.2d 883 (Ct. Cl. 1967); John E. MacDonald, Jr., 52 T.C. 386 (1969).

[184]Ehrhart v. Commissioner, 470 F.2d 940, 944 (1st Cir. 1973), *aff'g* 57 T.C. 872 (1972); John E. MacDonald, Jr., 52 T.C. 386, 393 (1969).

[185]Commissioner v. Ide, 335 F.2d 852 (3d Cir. 1964), *aff'g* 40 T.C. 721 (1963).

Payments of tuition, fees, book expenses, and relocation expenses to a student who had secured employment at a Navy research laboratory through competitive examination and had subsequently been granted an educational leave with a requirement of continued employment upon graduation, however, were held to be compensation for past, present, or future services. Rev. Rul. 58-403, 1958-2 CUM. BULL. 49.

Payments to persons attending military academies and to veterans are specifically mentioned as not being scholarships. Commissioner v. Ide, *supra*, at 854; Treas. Reg. § 1.117-4(a), (b) (1956).

[186]Commissioner v. Ide, 335 F.2d 852, 855 (3d Cir. 1964).

[187]This reasoning was employed in a Third Circuit decision which was overruled by the Supreme Court. Bingler v. Johnson, 394 U.S. 741 (1969), *rev'g* 396 F.2d 258 (3d Cir. 1968).

[188]*See, e.g.*, Bingler v. Johnson, 394 U.S. 741 (1969); Jonathan M. Kagan, 28 CCH Tax Ct. Mem. 617 (1969).

[189]*See, e.g.*, Jerry S. Turem, 54 T.C. 1494 (1970); John E. MacDonald, Jr., 52 T.C. 386 (1969).

[190]Ehrhart v. Commissioner, 470 F.2d 940 (1st Cir. 1973), *aff'g* 57 T.C. 872 (1972).

ingly, the employer-employee relationship is not severed, or even suspended, during the leave period, since the employee retains his job seniority and continues to receive employee fringe benefits such as health and life insurance, sick leave,[191] and retirement or profit-sharing benefits.[192] In addition, a stipend often is a continuation or a stated percentage of a recipient's salary and is not based on financial need or educational expenses.[193] Even if the amount of a payment were based upon need, however, there is some authority to the effect that the result would not be altered.[194] Employer administrative practices in making stipend payments from general funds and withholding income taxes also are deemed supportive of a finding that a grant is compensation.[195]

Some grantors require progress reports or even more closely direct a recipient's course of study. Conduct of this nature is considered inconsistent with the normal characteristics of a scholarship.[196] In a majority of cases, however, grantors exercise no control over the course of study other than to designate the general area in which study may be undertaken. Nonetheless, this absence of direction or supervision is not sufficient to overcome other indicia that a grant is intended as compensation.[197]

Employees of city or county welfare agencies frequently argue that they are not employees of the grantor since the funds for educational stipends to these employees are provided by state and federal agencies. The absence of any direct economic benefit to the grantor in this situation, however, does not support the conclusion that the payments are made for a reason other than the grantor's own interest. Any result which is helpful in fulfilling a governmental function, such as increasing the staff of work-

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[191]*See, e.g.*, James G. Harper, 31 CCH Tax Ct. Mem. 424 (1972); Eugene W. Helms, 31 CCH Tax Ct. Mem. 442 (1972).

[192]*See, e.g.*, Norman F. Stougaard, 30 CCH Tax Ct. Mem. 1331 (1971); Marjorie E. Haley, 54 T.C. 642 (1970).

[193]*See, e.g.*, Bingler v. Johnson, 394 U.S. 741 (1969); Norman F. Stougaard, 30 CCH Tax Ct. Mem. 1331 (1971).

[194]Norman F. Stougaard, 30 CCH Tax Ct. Mem. 1331, 1336 (1971). Although the payment in question here was not based on financial need, there is dictum to the effect that meeting such a criterion would not affect the decision in the case.

[195]*See, e.g.*, Bingler v. Johnson, 394 U.S. 741 (1969); Norman F. Stougaard, 30 CCH Tax Ct. Mem. 1331 (1971).

[196]Bingler v. Johnson, 394 U.S. 741 (1969) (thesis topic must be submitted to the employer with approval based on whether the topic bears at least some relationship to the work being done for the employer); John E. MacDonald, Jr., 52 T.C. 386 (1969) (recipient must state why the field in which study is to be undertaken is important to the employer, and approval is based on the relation of the field of study to the areas of primary interest of the employer).

[197]*See, e.g.*, Norman F. Stougaard, 30 CCH Tax Ct. Mem. 1331 (1971).

ers trained to provide social services, is a benefit to the grantor. Therefore, if the funds are administered by the city or county agency which receives a direct benefit from the recipient's services, the stipend is compensation for those services.[198]

Benefit to the grantor remains the key to characterizing an educational grant either as a scholarship or as employee compensation. Factual situations are interpreted with respect to the definition of a scholarship as a relatively disinterested educational grant with no requirement of any substantial quid pro quo flowing from the recipient to the grantor.[199] This view of the facts frequently leads to the conclusion that grants to employees from their employer are not intended primarily to further the education of the recipient in an individual capacity, with any benefit to the grantor being merely incidental.[200] In effect these grants often support training programs which enable recipients to better perform their duties as employees. This is the stated objective of many corporate scholarship plans.[201] From an employer's point of view, the business purpose transcends any desire to further an employee's education per se; the grants are analogous to a bonus designed to induce improved performance or employee relations.[202] Since there is a direct benefit to the grantor-employer, the grant is compensation.[203]

In *Laurence E. Broniwitz*,[204] the only case in the area that still has precedential value, a taxpayer convinced the court that a grant from his employer was a scholarship. *Broniwitz* indicates that exclusion in the grantor-employer context is possible only in exceptional circumstances. The recipient was an outstanding student who learned of the grant from a notice on a university scholarship bulletin board. He was not employed by the grantor prior

[198]Ulak v. United States, 1972-1 U.S. Tax Cas. ¶ 9468 (S.D. Cal. 1972); Jerry S. Turem, 54 T.C. 1494, 1506-07 (1970); Marjorie E. Haley, 54 T.C. 642, 646 (1970).

[199]This problem is not limited solely to industrial employees. A college professor participating in a cooperative educational research training program leading to a Doctor of Philosophy degree at his college received a percentage of his former salary, hospitalization, and insurance. In addition, his thesis covered a problem of interest to the sponsoring college. The grant was determined to be payment for services subject to the direction of, and primarily for the benefit of, the grantor. Rev. Rul. 71-417, 1971-2 CUM. BULL. 96.

[200]Bingler v. Johnson, 394 U.S. 741, 751 (1969).

[201]Fellowship Report, *supra* note 169, at 25.

[202]Robert H. Kyle, 31 CCH Tax Ct. Mem. 327, 331 (1972).

[203]*See, e.g.*, Ehrhart v. Commissioner, 470 F.2d 940 (1st Cir. 1973), *aff'g* 57 T.C. 872 (1972); Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961); Michael A. Smith, 60 T.C. 279 (1973); James G. Harper, 31 CCH Tax Ct. Mem. 424 (1972); Jerry S. Turem, 54 T.C. 1494 (1970); Marjorie E. Haley, 54 T.C. 642 (1970).

[204]27 CCH Tax Ct. Mem. 1088 (1968).

to receiving the grant and never performed services for the company. He was classified as an employee, however, because this was necessary to his eligibility for educational assistance. The grant paid tuition, book expenses, and a living stipend based on need and academic ability. No control or supervision was exercised by the grantor beyond requiring the submission of progress reports. Even these reports concerned academic activities only and not the substance of the recipient's research project. Furthermore, no obligation of employment following graduation existed, and, in fact, the recipient was not so employed. The recipient was committed to work part-time for the grantor during the summers between school terms. For this he was paid a salary, commensurate with the position held, in addition to and completely separate from his scholarship. Under these circumstances, it was determined that the grant was not compensation for past, present, or future services since the recipient was paid adequately for the part-time employment and the only benefit to the grantor was the incidental possibility of recruiting the recipient for employment after graduation. For these reasons, the primary purpose of the grant was construed as assistance to an outstanding student's education.[205]

In addition to providing scholarship grants, many companies also have programs which reimburse tuition expenses of employees who are part-time students. These plans have similar objectives to those of employee scholarship plans: to make employees more productive and more able to advance within the company.[206] The field of study generally is restricted to those areas related to an employee's present or projected future work assignment.[207] While recipients of tuition-aid are encouraged to continue working for the grantor, nearly all such grants have no requirement of future employment.[208] Companies granting tuition reimbursement generally consider such a plan to be an employee fringe benefit.[209]

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[205]*Id.* at 1093.

[206]The stated objectives in order of frequency of occurrence are: to enable employees to get ahead in the corporation, to make employees more productive, to enrich the employees' lives, to create a reserve of promotable employees, to attract new employees, and to update the employees' knowledge. Tuition-Aid Report, *supra* note 170, at 12.

[207]*Id.* at 39.

[208]*Id.* at 24. Out of 200 plans studied, only 8 require employees to continue their employment after receiving tuition aid. The length of service required by these few companies ranges from six months to five years, with the longer period applying only in the case of personnel who receive a doctoral degree.

[209]*Id.* at 12. Only 35 of the 200 participating companies do not consider tuition-aid plans to be an employee fringe benefit.

Most of these companies do not withhold income tax from tuition-aid grants.[210]

No cases have arisen dealing directly with tuition grants by employers. This may result from the deduction of educational costs as business expenses rather than the exclusion of them from gross income as scholarships.[211] There have been several instances, however, when the exclusion of a stipend or living allowance has been disallowed, but payments for tuition and fees have not been in issue.[212] Thus, the income tax status of tuition-aid grants is somewhat speculative. While it is apparent that these payments, at least theoretically, are taxable compensation under the present interpretation of section 117,[213] the Internal Revenue Service is not challenging the excluson of these grants from gross income. This may represent a policy decision that a grant, limited by normal educational expenses and bearing no relation to compensation for services, deserves an exclusion because of the strong national interest in encouraging continued education.

In summary, educational grants to employees from their employer, while the recipient is on educational leave and performing no services for the employer, are taxable compensation for past, present, or future services. An educational grant to an employee from an employer is a scholarship only in the rare case of a nominal employee who performs no employment services at any time. Similarly, reimbursement of an employee's tuition expenses by the employer constitutes taxable compensation, although the exclusion from gross income of such grants is not being challenged at present.

B. Non-Degree Candidates

The quest for a university degree is not a prerequisite to obtaining an educational grant. Many grants are given for the purpose of broadening the recipient's knowledge and expertise.[214]

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[210]*Id.* at 77. Only 64 of the 200 participating companies withhold income tax from such grants. The plans of the companies which do withhold usually state that reimbursement under the plan is considered to be additional compensation.

[211]In Bingler v. Johnson, 394 U.S. 741, 744 n.9 (1969), the Supreme Court, while noting that the tax status of the tuition reimbursement payment was not at issue in the case, stated that "although conceptually includable in the income, such sums presumably would be offset by educational deductions."

[212]Bingler v. Johnson, 394 U.S. 741 (1969); Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961); Jerry S. Turem, 54 T.C. 1494 (1970); John E. MacDonald, Jr., 52 T.C. 386 (1969).

[213]INT. REV. CODE of 1954, § 117.

[214]Examples of such grants are stipends paid to writers by tax-exempt organizations. Such stipends are fellowships and excludable from gross income.

In this situation, a typical grantor exercises no control over the subject matter of the work and does not supervise a recipient's activities, although reports outlining the use of the funds and the accomplishments achieved under the grant frequently are required. Rights to any discoveries or work produced under the grant remain with the grant recipient.

In determining whether these grants possess the normal characteristics of a fellowship and are excludable under section 117,[215] the only criterion of any importance is whether the activities of the recipient result in benefit to the grantor. When there is no employment relationship between the grantor and the recipient, either prior to or during the period of the grant, and no obligation of future employment, the grant generally fits the classical description of a fellowship. It is regarded as a relatively disinterested educational grant with no requirement of any substantial quid pro quo. Mandatory progress reports and incidental benefit to the grantor are, in themselves, insufficient to destroy the grant's essential character as a fellowship.[216]

If, however, a stipend is paid to a non-degree candidate employee by his employer, difficulty is encountered in showing that the grant is not encumbered with the obligation of a quid pro quo. This difficulty occurs even though amounts paid for the primary purpose of furthering a recipient's education are excludable despite their compensatory nature.[217] When training obtained by a recipient is job-related, the failure of the training to lead to a degree presents strong evidence that the benefit accrues principally to the employer.

A grant from an employer to a non-degree candidate employee may result in a benefit to the grantor in two distinct situations. The first situation arises when the employer is the grantor and a stipend is paid during a period when no actual services are performed by the recipient for the employer. These

Rev. Rul. 72-168, 1972-1 CUM. BULL. 37; Rev. Rul. 72-163, 1972-1 CUM. BULL. 26. Further examples are the Andrew Mellon Fellowships to applicants studying in the humanities or social sciences. Rev. Rul. 73-88, 1973-1 CUM. BULL. 52.

[215]A non-degree candidate is, of course, limited in the source, amount, and period of the fellowship which may be excluded from gross income. INT. REV. CODE of 1954, § 117(b)(2). The problems arise, however, in making the initial determination of whether the grant is a scholarship.

[216]Rev. Rul. 58-76, 1958-1 CUM. BULL. 56 (recipient of an American Heart Association Research Fellowship grant to further the training in cardiovascular research was required to devote full time to research).

[217]Frank T. Bachmura, 32 T.C. 1117, 1125-26 (1959). The proposition that, in the proper circumstances, a fellowship grant could be compensatory in nature was stated, although the facts of this particular case led to the conclusion that the stipend in question was not a fellowship.

amounts represent continued compensation if the training is part of the recipient's duties as an employee and, therefore, primarily of benefit to the employer.[218] This conclusion is valid even when an employee is not *required* to return to work upon his completion of training, but it is expected that continued employment will occur.[219]

In the second situation, services are performed for an organization other than the original grantor. If this organization considers the grant recipient to be an employee and duties are performed for its benefit, the grant is compensation for those services.[220] The absence of some of the usual employee benefits and the presence of an excellent opportunity for study are not determinative of the character of the grant.[221] The use of the grant funds often is restricted by the grantor to furthering the organization's function and assigned projects. The organization in this situation has no authority to use the funds to finance individual educational goals, and payment of the grant is made for the organization's own benefit.[222]

Amounts received by teachers participating in programs and workshops designed to improve the quality of education fall into one or the other of the above categories depending upon the source of the funds. These amounts generally are considered compensation. For example, grants commonly are made either by school boards which regularly employ the teachers[223] or through federal

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[218]*See, e.g.*, Marjorie Schwartz, 28 CCH Tax Ct. Mem. 762 (1969) (high school language teacher continued to receive her salary while on leave for five months to study at the Sorbonne in preparation for teaching a new course in modern European thinking).

[219]*See, e.g.*, David E. Mark, 26 CCH Tax Ct. Mem. 1106 (1967) (foreign service officer who received his salary while a fellow of the Harvard Center for International Affairs was considered by the State Department as being on official duty at the time).

[220]*See, e.g.*, Beulah M. Woodfin, 31 CCH Tax Ct. Mem. 208 (1972) (post-doctoral research assistant at a university under a National Science Foundation grant); Howard Littman, 42 T.C. 503 (1964) (research associate at Argonne Laboratory operated for the Atomic Energy Commission by the University of Chicago); Norman R. Williamsen, 32 T.C. 154 (1959) (student at Oak Ridge School of Reactor Technology operated for the Atomic Energy Commission by Union Carbide Corp.); Frank T. Bachmura, 32 T.C. 1117 (1959) (research associate at a university under a Rockefeller Foundation grant).

[221]Harvey P. Utech, 55 T.C. 434, 440 (1970) (post-doctoral research associate at the National Bureau of Standards under a National Academy of Science grant).

[222]*Id.* at 436; Howard Littman, 42 T.C. 503, 509 (1964). If it is exceptionally clear, however, that the grantor gains no benefit from the recipient's activities, use of funds for unauthorized purposes does not change the substance of a true fellowship arrangement. Louis C. Vaccaro, 58 T.C. 721 (1972).

[223]Marjorie Schwartz, 28 CCH Tax Ct. Mem. 762 (1969); Rev. Rul. 70-518, 1970-2 CUM. BULL. 20 (state training program to improve public school

grants administered by a university or state agency which is sponsoring the program.[224] It is deemed unrealistic to conclude that a school would encourage its teachers to participate in these programs if it did not expect to derive the principal benefit of improving the quality of education. It is not considered significant that the grant recipients receive a substantial educational benefit or that the programs contribute to the general education of school children.[225] Participation in these activities appears to be inextricably tied to the recipient's status as an employee.

An inconsistent ruling was made, however, in the case of a school principal who was allowed administrative leave of absence to attend a leadership development program to advance education in rural, disadvantaged schools.[226] The recipient's activities included study, research, and observation of innovative programs with a view toward implementation in a rural school environment. The program sponsor paid the funds to the employer school board for disbursement to the recipient. Nonetheless, no employment relationship was found because neither the sponsor, nor the school board, nor the principal considered the disbursing function to be a requirement of the fellowship grant or related to the recipient's employment. The stipend, therefore, was found to be a fellowship. This holding is contrary to the generally applied principle that any entity in the chain of administration of the grant which receives benefit from the recipient's increased training is considered to be a grantor.[227]

Although it is difficult to negate the implication of benefit to an employer-grantor, this result is possible under circumstances which clearly show that the educational purpose predominates and that any benefit derived by the grantor from the recipient's activities during his training is merely incidental. Thus, fellows at an institute designed for extensive individual study and

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instruction); Rev. Rul. 67-239, 1967-2 CUM. BULL. 73 (program to improve education in desegregated schools); Rev. Rul. 67-212, 1967-2 CUM. BULL. 72 (workshop to assist children of low-income families).

[224]Robert W. Willie, 57 T.C. 383 (1971) (HEW grant to study education in desegregated schools); Rev. Rul. 68-312, 1968-1 CUM. BULL. 59 (National Teacher Corps grant for teaching underprivileged children was compensation to experienced teachers participating in the program but was a scholarship to student-interns pursuing studies leading to advanced degrees); Rev. Rul. 68-146, 1968-1 CUM. BULL. 58 (National Science Foundation grant to raise the academic quality of colleges); Rev. Rul. 61-174, 1961-2 CUM. BULL. 28 (HEW grant to develop a new teaching approach to algebra).

[225]Robert W. Willie, 57 T.C. 383, 389 (1971).

[226]Rev. Rul. 69-472, 1969-2 CUM. BULL. 13.

[227]Ulak v. United States, 1972-1 U.S. Tax Cas. ¶ 9468 (S.D. Cal. 1972); Jerry S. Turem, 54 T.C. 1494, 1506-07 (1970); Marjorie E. Haley, 54 T.C. 642, 646 (1970).

independent research, who neither performed the duties of nor replaced staff personnel, were not considered to be employees.[228] Similarly, a university professor who received a grant which, although administered by an employer university, would follow the recipient should he move to another university was not considered to be an employee for the purposes of the grant.[229] In both cases, the stipends were held to be fellowships.

It is also possible that a grant from an entity other than an employer is compensation. If grants are made to persons of proven originality, experience, and ability, and the legal rights to any discoveries arising from research under the grant are assigned to the grantor, the conclusion may be drawn that the primary purpose of the grant is to benefit the grantor. The grantor has bargained for the services and products of the recipient, and the recipient has received compensation in return.[230]

In summary, grants to non-degree candidate employees from the employer generally are compensation. Only in the rare instance in which the circumstances show that no significant benefit from the recipient's activities accrues to the grantor is a stipend a fellowship. Grants to non-degree candidates from a grantor who is not the recipient's employer are fellowships unless the legal rights to discoveries or products arising under the grant are assigned to the grantor.

V. Conclusion

Few solid rules can be formulated which will guide one in determining that a grant requiring services is a scholarship or fellowship. It often has been stated that if the primary purpose of a grant is to further the education and training of a recipient in an individual capacity, the grant is a scholarship. This statement, however, is not a rule which may be applied mechanically but is a conclusion drawn from the collection of facts which are variously weighted depending on the circumstances. Nonetheless, a few general guidelines may be postulated. Many can only be stated

[228]Rev. Rul. 71-538, 1971-2 Cum. Bull. 97. The fellow was led through several stages of development as a research scientist: library work, observation of research projects, work on a project under supervision, and finally independent work on a project of the fellow's own choosing. It was not expected that the activities of the fellow would provide a net benefit to the grantor.

[229]Clarence Peiss, 40 T.C. 78 (1963). The grant was received in addition to the recipient's regular salary and for activities not requires of the recipient as an employee.

[230]Rev. Rul. 71-379, 1971-2 Cum. Bull. 100 (American Heart Association Established Investigator Awards to experienced researchers); Rev. Rul. 72-263, 1972-1 Cum. Bull. 40 (National Institutes of Health grant to a physician doing post-doctoral research at a medical school); Rev. Rul. 73-564, 1973-2 Cum. Bull. 28 (foundation grant to a college professor for research work).

as practices to be avoided so as not to disqualify a grant, rather than as practices to be followed to qualify a grant as a scholarship.

Grants to medical residents have been given the most consistent treatment by the courts. These grants are scholarships only in the rare instance when a recipient's activities are largely observational or highly supervised and when it is obvious that a hospital could continue to function at the same level without the services of the resident. Similarly, educational grants given to employees by their employer nearly always are compensation. However, in this situation, a grant qualifies as a scholarship if the employment relationship is completely severed, which requires a stipend based on financial need rather than previous salary, and an absence of employee benefits and of services performed for the grantor during the period of the grant. No obligation or expectation of continued employment can exist. In addition, the rights to the product of the research or study must not inure to the benefit of the grantor.

Conversely, graduate assistantship research grants usually are scholarships when substantially equivalent activities under the direction of the degree-granting department are required of all degree candidates and academic credit is given. The status of teaching assistantship stipends, however, is not as firmly settled as that of research grants. A more clearly demonstrated absence of benefit to the university is required of teaching assistants before a teaching stipend is excludable. Also, the responsibility given the grant recipient must be severely limited and the number of such grants offered must not be based on the university's need for teachers.

Between these extremes are other grants offered by universities and charitable and governmental agencies, either directly to the recipient or through the beneficiary of the services. The income tax status of these grants seems to be determined by weighing the facts on each side and then reaching a decision based on the totality of the circumstances.

Definite steps can be taken to enhance the probability of a determination that a given stipend is a scholarship or fellowship. In the case of grants to degree candidates, the activities required of the recipients should be considered part of a particular course of study for which academic credit is given. In addition, the amount of the grant should be based on financial need, education expenses, or academic ability and must bear no relation to the salary which is paid for similar services in an employment relationship. Administratively, such stipends should be treated as any other university scholarship as to the selection of recipients, the account from which it is paid, and income tax

withholding. The university brochures should refer to the grants as "scholarships" and to the recipients as "students." The words "salary" and "employee" must be avoided.

Whether or not a recipient is a degree candidate, no prior or subsequent employment relationship between the grantor and the recipient should exist. Furthermore, a grantor must not receive any rights in the product of the research or study and the activities of a recipient should not be directly related to the fulfillment of a contract or the general function of the grantor. Lastly, it is imperative that a recipient does not replace regular employees whom it otherwise would be necessary to hire.

To digress briefly into the realm of theoretical policy considerations, if Congress truly believed that continued education so substantially serves the national interest as to merit encouragement through specific, favorable tax treatment, the courts have gone too far in finding that compensation underlies many of these grants. Many payments seem to further this national interest as well as do grants conditioned on the performance of services required of all degree candidates or which have a source other than the recipient's employer. These include payments supporting activities which are a part of a curriculum and for which academic credit is received, and company tuition-aid payments which are in addition to the salary paid, whether or not the recipient also receives a grant, and which require no additional services performed for the grantor. The purpose of a recipient in performing services as well as the purpose of a grantor in requiring such activities should be considered. Ultimately, a finding that the education and training of a recipient is substantially furthered and the grantor derives only indirect benefit from the services should result in a determination that the grant falls within the exclusionary provisions of section 117.

Whether this position is correct, however, is of only academic interest at present. The only practical course of action, for both the grantor and the recipient, is to tailor their activities so as to make the best of the situation as it now exists.

Comment

Bank Liability for Wrongful Dishonor: UCC Section 4-402 – Is Revision Needed?

WILLIAM L. DANIELS*

I. INTRODUCTION

The introduction of the Uniform Commercial Code (UCC) and its original subjection to legal scrutiny[1] naturally were accompanied by some objection to and criticism of its provisions.[2] Some critics contended that Articles 4 and 5 unduly favored banking interests and the commercial community.[3] Despite this

*Assistant Professor of Law, Illinois Institute of Technology, Chicago-Kent College of Law; B.A., Arizona State University, 1968; J.D., Loyola University, 1971.

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[1]The first state legislature to adopt the Uniform Commercial Code (UCC) was Pennsylvania. PA. STAT. ANN. tit. 12A §§ 1:01 *et seq.* (1970) (effective July 1, 1954). All states except Louisiana now have adopted the UCC.

For a history of the early formulation of the UCC see 1953 HANDBOOK OF THE NATIONAL CONFERENCE OF UNIFORM STATE LAWS 147; Beers, *New Steps Toward Uniformity—The Commercial Code*, 20 CONN. B.J. 80 (1946); Garret, *The Project of the Formulation by the American Law Institute of a Commercial Code*, 19 FLA. L.J. 35 (1945); Schnader, *A Short History of the Preparation and Enactment of the Uniform Commercial Code*, 22 U. MIAMI L. REV. 1 (1967).

[2]*See* Beutel, *The Proposed Uniform Commercial Code as a Problem on Codification*, 16 LAW & CONTEMP. PROB. 141 (1951); Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334 (1952); Braucher, *The 1956 Revision of the Uniform Commercial Code*, 2 VILL. L. REV. 3 (1956); Gilmore, *On the Difficulties of Codifying Commercial Law*, 57 YALE L.J. 1341 (1948); Vergari, *Suggested Amendments to the Uniform Commercial Code*, 72 BANKING L.J. 621 (1955). *See also Symposium—Amending the Uniform Commercial Code: A Report on Valid Criticism and Suggested Change*, 28 TEMPLE L.Q. 511 (1956). The following articles appeared in this *Symposium:* Braucher, In re *Article 7, id.* at 564; Hawkland, In re *Articles 1, 2 and 6, id.* at 512; Spivack, In re *Article 9, id.* at 529; Thomas, In re *Article 8, id.* at 582; Vergari, In re *Articles 3, 4 and 5, id.* at 529.

[3]See Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334 (1952). Professor Beutel called Article 4 "an unfair piece of class legislation maneuvered through the American Law Institute and the Commission on Uniform Laws by pressure groups favoring the

alleged favoritism, however, the UCC has found general acceptance in the United States. The early criticism, which often demanded outright rejection of the Code, has yielded to constructive commentary suggesting judicious amendments. The trend is now toward improvement rather than complete rejection.[4] Section 4-402, which concerns a payor bank's liability for wrongful dishonor of a customer's check,[5] is one section that could benefit from judicious revision. While its subject matter was clearly appropriate for codification, the present version of section 4-402 does not appreciably improve the unsatisfactory and nonuniform results that arose under common law wrongful dishonor rules and previous codifications.

More than ever before, an individual's or an entity's credit rating is a key to viable commercial relations. Modern business practices rely heavily upon the use of credit to finance and to consummate purchases made by businesses and consumers. Highly computerized credit ratings generally dictate the amount of credit that can be extended to a potential purchaser. Congress, by enacting the Fair Credit Reporting Act,[6] recognized the importance of credit ratings and the need for their meticulous accuracy. The Act is intended to maintain accuracy in credit reporting and to provide remedies for abusive reporting practices. As a result of the increased importance and sophistication of credit ratings, the need for more rational and balanced rules concerning a bank's liability for the wrongful dishonor of a check is even more acute than when section 4-402 was first enacted.

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bankers over their customers." *Id.* at 335. Furthermore, Professor Beutel explained this one-sidedness of Article 4 by stating: "This article is a deliberate sell-out of the American Law Institute and the Commission on Uniform Laws to the bank lobby in return for their support of the rest of the 'Code.'" *Id.* at 362. In a reply article, Professor Gilmore rebutted some of Professor Beutel's criticism but agreed, at least in principle, that Article 4 should not be adopted. He also conceded to Professor Beutel that Article 4 had been proposed by a group of bank counsel in 1950 and adopted by the Institute and Conference in September, 1951. *See* Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364 (1952).

[4]*Cf.* Martin, *The Uniform Commercial Code—Should It Be Amended by the Courts or by the Legislatures?*, 36 N.Y. ST. B.J. 209 (1964); Penny, *New York Revisits the Code: Some Variations in the New York Enactment of the Uniform Commercial Code*, 62 COLUM. L. REV. 992 (1962); Whiteside, *Amending the Uniform Commercial Code*, 51 KY. L.J. 3 (1962).

[5]Section 4-402 refers to "items." It is possible, therefore, for obligations other than checks to be dishonored, including instruments drawn against a savings account. Most wrongful dishonor cases, however, have involved the dishonor of a customer's check. *See, e.g.*, Joler v. Depositors Trust Co., 309 A.2d 871 (Me. 1973).

[6]15 U.S.C. §§ 1681(a)-(t) (1970).

A sound credit rating can be impaired or even destroyed by the negotiation of a check which is subsequently returned, stamped with the legend "not sufficient funds" or "insufficient funds." When the insufficiency is caused by the drawer's fault, he alone bears the negative consequences. When an incorrect notice of insufficiency is precipitated by the payor bank, however, the drawer is entitled to reimbursement for some part of the injury caused by the dishonor. The nature of the relationship between the bank and its customer, together with the permissible extent of the bank's liability for the wrongful dishonor,[7] largely determines which of the drawer's injuries are compensable.

The problem of a bank's liability for wrongful dishonor has been confronted by common law doctrines, the American Banking Association's proposed statute regarding wrongful dishonor (ABA statute),[8] and finally section 4-402 of the Uniform Commercial Code. The results have neither been consistent nor entirely logical. This Comment briefly traces common law principles governing a bank's liability for wrongful dishonor, the effect of the ABA statute, and the enactment of Uniform Commercial Code section 4-402. An amended section 4-402, which is intended to avoid some of the pitfalls of the present section, is then proposed.

II. Common Law Doctrines

> I think it cannot be denied, that, if one who is not a trader were to bring an action against a banker for dishonoring a check at a time when he had funds of the customer's in his hands sufficient to meet it, and special damages were alleged and proved, the plaintiff would be entitled to recover substantial damages.[9]

This statement sets forth the general common law rule of recovery in situations in which a bank has wrongfully dishonored

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[7]Comment 2 to section 4-402 defines wrongful dishonor in the following manner:

> "Wrongful dishonor" excludes any permitted or justified dishonor, as where the drawer has no credit extended by the drawee, or where the draft lacks a necessary indorsement or is not properly presented.

The Comment actually fails to state the most common situation of wrongful dishonor—when the drawer has adequate funds to cover the item drawn upon the proper account. This is distinguishable from the situation in which the drawee has committed credit to the account and then dishonors the item.

[8]1 T. Paton, Digest of Legal Opinions § 21B:1, at 1117 (1940) [hereinafter cited as Paton's Digest]. Eighteen states at one time had adopted this statute. They are Alabama, Arkansas, California, Idaho, Illinois, Maine, Michigan, Missouri, New Jersey, New Mexico, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Virginia, West Virginia and Wyoming. *Id.* at 1118.

[9]Rolin v. Steward, 139 Eng. Rep. 245, 250 (C.P. 1854) (Williams, J.).

a customer's check. The majority of English and American courts followed this rule throughout most of the nineteenth and twentieth centuries. It remained in force in this country until the enactment of the Uniform Commercial Code by most states. Nevertheless, much of the common law is still viable today, and an understanding of its substance greatly facilitates an understanding of section 4-402. A bank's liability for wrongful dishonor may rest on two common law bases: tort and contract.

A. Contract Liability

Courts were quick to clothe bank-customer transactions with the trappings of contract law. Banks often promised to pay all checks that were drawn by their customers so long as the customer's account contained sufficient funds. If there were sufficient funds to pay only several of a number of checks presented, banks were obligated to honor as many as they could.[10] Under the basic rules of contracts set forth in *Hadley v. Baxendale*,[11] damages for breach are to be apportioned. Some damages flow naturally from the breach, while other damages are considered to be reasonably within the contemplation of the parties at the time of the contract. For example, in *Wahrman v. Bronx County Trust Co.*,[12] the plaintiff sought special damages for a cancelled insurance policy caused by a wrongfully dishonored check. The court stated that to recover for special damages the plaintiff was required to plead and prove "that the defendant had actual or constructive knowledge of the consequences reasonably to be expected from the nonpayment of the check."[13] This knowledge, the court held, could not be inferred solely from the fact that an insurance company was the payee. Under this theory, bank customers were limited to recovery of damages that would place them in substantially the same position as they would have occupied had the contract been performed. On the other hand, damages for loss of expected credit and mental suffering were not recoverable since they generally were not within the contemplation of the parties at the creation of the contract.[14]

B. Tort Liability

A tort action similar to slander represented another method

[10]Reinisch v. Consolidated Nat'l Bank, 45 Pa. Super. 236 (1911); Dana v. Third Nat'l Bank, 95 Mass. 445 (1866).

[11]156 Eng. Rep. 145 (Ex. 1854).

[12]246 App. Div. 220, 285 N.Y.S. 312 (1936).

[13]*Id.* at 221, 285 N.Y.S. at 313. *Cf.* American Nat'l Bank v. Morey, 113 Ky. 857, 69 S.W. 759 (1902).

[14]Wahrman v. Bronx County Trust Co., 246 App. Div. 220, 285 N.Y.S. 312 (1936).

of recovery at common law. A bank's wrongful dishonor was considered a false statement that placed a drawer in disrepute in the business community.[15] Indeed, a wrongful dishonor, when applied to a customer engaged in a profession or trade, was considered slanderous per se. In an action for slander the plaintiff was not required to plead or prove special damages, since special damages were presumed to flow from the fact of publication.[16] Consequently, in actions for wrongful dishonor based on tort, it was within the province of the jury to consider actual monetary damages as well as such "other damages as necessarily arise out of the act; and . . . if the effect of such damage is to produce mental suffering and anxiety, they are at liberty to award damages on that head, also."[17]

In circumstances involving wrongful dishonor, the advantages of a tort action rather than a contract action are obvious. Tort damages are compensatory and provide relief for all injuries proximately caused by a wrongful dishonor.[18] Nevertheless, reliance upon a tort theory did not necessarily mean that a customer could have recovered for all his injuries. For example, damage to a person's credit standing often arises from wrongful dishonor, but credit is an elusive concept and loss is difficult to prove. Moreover, any claim for injury to a person's credit rating could be defeated by the argument that the dishonor did not proximately cause the diminution. An individual's credit standing is a composite of various intangible criteria, any of which could affect his total financial status.

C. The Trader Rule

The use of checks traditionally has been limited to a commercial context, and the trader rule modification of the two common law theories of damages was formulated to accommodate the business community. Accordingly, if a plaintiff were a trader, damages normally associated with tort actions were available as conclusively presumed contract damages.[19] Notably, a plaintiff did not need to show that the injury was within the contempla-

[15]*See* Schaffner v. Ehrman, 139 Ill. 109, 28 N.E. 917 (1891); Weiner v. North Penn Bank, Inc., 65 Pa. Super. 290 (1916).

[16]*See* W. PROSSER, LAW OF TORTS § 112, at 757-59 (4th ed. 1971).

[17]Davis v. Standard Nat'l Bank, 50 App. Div. 210, 214, 63 N.Y.S. 764, 767 (1900).

[18]Those courts allowing a tort recovery have identified specific torts in certain cases of wrongful dishonor. *Cf., e.g.*, Macrum v. Security Trust & Sav. Co., 221 Ala. 419, 129 So. 74 (1930) (defamation); Schaffner v. Ehrman, 139 Ill. 109, 28 N.E. 917 (1891) (slander); Nealis v. Industrial Bank of Commerce, 200 Misc. 406, 107 N.Y.S.2d 264 (Sup. Ct. 1951) (libel).

[19]In this context the word "trader" or "merchant" meant any bank customers engaged in business. In Peabody v. Citizens' State Bank, 98 Minn. 302,

tion of the parties. Moreover, proof that a plaintiff was not, in fact, injured by the dishonor did not defeat his action but merely mitigated his damages.[20]

While some courts were liberal in applying the trader rule to nontraders,[21] most maintained the distinction between traders and nontraders.[22] Special damages suffered by a nontrader, therefore, still were required to be pleaded and proved, and failure to do so limited recovery to only nominal damages for a technical breach of contract.[23] Apparently, courts accepted the idea that the dishonor of a check did substantially less damage to the reputation of a person not engaged in mercantile activities than it did to a "trader."

The generally accepted trader rule essentially involved a two-step method of proof: first, proving wrongful dishonor, and secondly, proving the plaintiff's status as a trader.[24] New York courts

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310, 108 N.W. 272, 276 (1906), it was stated that "a trader originally meant a shopkeeper—that is, a tradesman; but it now in this connection means merely a businessman." *See* PATON'S DIGEST, *supra* note 8, § 21A:1.

[20]First Nat'l Bank v. N.R. McFall & Co., 144 Ark. 149, 222 S.W. 40 (1920). For example, in Rolin v. Steward, 139 Eng. Rep. 245 (C.P. 1854), the trader rule was described in the following manner:

> [W]hen it is alleged and proved that the plaintiff is a trader, I think it is equally clear that the jury, in estimating the damages, may take into their consideration the natural and necessary consequences which must result to the plaintiff from the defendant's breach of contract: just as in the case of an action for a slander of a person in the way of his trade, . . . the action lies without proof of special damage.

Id. at 250 (Williams, J.).

Forty years later, in Shaffner v. Ehrman, 139 Ill. 109, 28 N.E. 917 (1891), the court expressed the same sentiment:

> It is well understood that in an action of slander by a person for the speaking of slanderous words of him in the way of his trade the fact he is a trader takes the place of special damages. To return a check marked "Refused for want of funds" to the holder, especially through a clearing-house, certainly tends to bring the drawer of that check into disrepute as a person engaged in mercantile business; and it needs no argument to show that a single refusal of that kind might often, and frequently does, bring ruin upon a businessman; and yet it is no more possible in either case to prove special or actual damages than it is for one charged with the commission of a crime to show specifically in what manner he has been injured.

Id. at 113, 28 N.E. at 919.

[21]*See* Patterson v. Marine Nat'l Bank, 130 Pa. 419, 18 A. 632 (1889); Lorick v. Palmetto Bank & Trust Co., 74 S.C. 185, 54 S.E. 206 (1906).

[22]*See, e.g.*, First Nat'l Bank v. Stewart, 204 Ala. 199, 85 So. 529 (1920).

[23]*Cf.* State Bank v. Marshall, 163 Ark. 566, 260 S.W. 431 (1924); T.B. Clark Co. v. Mount Morris Bank, 85 App. Div. 362, 83 N.Y.S. 447 (1903); Burroughs v. Tradesmen's Nat'l Bank, 87 Hun. 6, 33 N.Y.S. 864 (Sup. Ct. 1895).

[24] *See generally* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER

accepted the trader rule but included a three-step modification which necessitated proving a wrongful dishonor, proving that the dishonor was the result of "malice," and proving the plaintiff's trader status.[25] The "malice" element required a showing of intentional action and could be inferred from a bank's dishonor of checks after notice of the bank's error was given or from the bank's wrongful application of funds in the plaintiff's account to purposes other than the payment of checks.[26] Failure to show malice in a dishonor resulted in the recovery of only nominal damages. The requirement of malice did not mean that the dishonor must have been the product of hatred or malevolence. The necessity of proving malice was intended, however, to limit a bank's liability to nominal damages for the consequences of accident or mistake.[27]

Judicial confusion inevitably resulted from the availability of two separate causes of action for wrongful dishonor and the application of the trader rule to the awarding of damages. Some courts, having piously announced that an action for wrongful dishonor sounded in contract, proceeded to award damages based on tort.[28] Other courts attempted to explain the trader rule as either a simple tort or a simple contract action.[29]

Some courts, however, did make lucid attempts to explain the trader rule. In *Patterson v. Marine National Bank*,[30] for example, the court justified its recognition of the trader rule as a tort doctrine on public policy grounds. The court reasoned that banks are in the nature of quasi-public institutions and should be held responsible for the disorder created within the community when they wrongfully dishonor checks. The court postulated that

> the business of the community would be at the mercy of

THE UNIFORM COMMERCIAL CODE § 17-4, at 568-74 (1972) [hereinafter cited as WHITE & SUMMERS].

[25] *Id.*

[26] *See* Wildenberger v. Ridgewood Nat'l Bank, 230 N.Y. 425, 130 N.E. 600 (1921).

[27] *Id.* at 428, 130 N.E. at 600.

[28] *See* Allen v. Bank of America, 58 Cal. App. 2d 124, 136 P.2d 345 (1943); Citizens Nat'l Bank v. Importers & Traders Bank, 119 N.Y. 195, 23 N.E. 540, 1 N.Y.S. 664 (1890).

[29] *See* First Nat'l Bank v. Stewart, 204 Ala. 199, 85 So. 529 (1920); Weaver v. Grenada Bank, 179 Miss. 564, 178 So. 105, *suggestion of error overruled*, 180 Miss. 876, 179 So. 564 (1938) (tort).

[30] 130 Pa. 419, 18 A. 632 (1889). *Patterson* also has been advanced to support the application of the trader rule to nontraders. This extension of the court's public policy explanation recognizes that banks occupy a vital and influential position in the nonbusiness as well as the business community. *See, e.g.*, Schaffner v. Ehrman, 139 Ill. 109, 28 N.E. 917 (1891).

> banks if they could at their pleasure refuse to honor their depositors' checks and then claim that such action was the mere breach of an ordinary contract for which only nominal damages could be recovered unless special damages were proved.[31]

Another approach was utilized by courts which recognized the trader rule as a contract doctrine. To meet the test of *Hadley v. Baxendale*,[32] courts would infer a bank's knowledge of a trader's special circumstances.[33] A bank would then be considered to have had constructive knowledge of the effect of a dishonor on a trader customer. The inference was made even if the bank, in fact, was completely unaware of a customer's trader status at the time of contract.[34] Under this interpretation, the customer still was required to allege and prove special damages.[35]

The advent of the twentieth century brought changes in the law concerning wrongful dishonor. At that time, most American courts looked to the status of the plaintiff for the purpose of applying the trader rule.[36] Nontraders generally did not have the advantage of the conclusive presumption of special damages conferred to traders. The distinction between traders and nontraders, however, was rapidly becoming irrelevant. In the southern and western states, courts, seemingly in response to the newly rekindled Jeffersonianism of the "Agrarian Revolt" and its concomitant social equality,[37] were recognizing the unfairness of the trader rule. Some jurisdictions, cognizant of the effect of a wrongful dishonor upon an individual's standing within his community, extended the presumption of damages to nontraders.[38]

For example, in *Valley National Bank v. Witter*,[39] the court extended the presumption of special damages to nontraders because changing financial conditions had eliminated, to a large extent, the degree to which traders and nontraders relied upon credit in their financial transactions. The court noted that at the inception of judicial recognition of the trader rule "practically

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[31] 130 Pa. at 433, 18 A. at 633.

[32] 156 Eng. Rep. 145 (Ex. 1854).

[33] *See, e.g.*, Wiley v. Bunker Hill Nat'l Bank, 183 Mass. 495, 67 N.E. 655 (1903).

[34] *See, e.g., id.;* Spiegel v. Public Nat'l Bank, 184 N.Y.S. 1 (Sup. Ct. 1920).

[35] *See generally* First Nat'l Bank v. N.R. McFall & Co., 144 Ark. 149, 222 S.W. 40 (1920).

[36] *Cf.* WHITE & SUMMERS § 17-4, at 568.

[37] For a thorough study of this period and movement, see R. HOFSTADER, THE AGE OF REFORM (1955).

[38] Atlanta Nat'l Bank v. Davis, 96 Ga. 334, 23 S.E. 190 (1895); Grenada Bank v. Lester, 126 Miss. 442, 89 So. 2 (1921); Lorick v. Palmetto Bank & Trust Co., 74 S.C. 185, 54 S.E. 206 (1906).

[39] 58 Ariz. 491, 121 P.2d 414 (1942).

all of the business of a merchant or trader was based upon credit rather than cash."[40] It was logical to presume, therefore, that any attack upon the trader's financial status would diminish his ability to obtain credit. Nontraders, on the other hand, "seldom had a bank account, conducted most of [their] dealings for cash, and only required credit in isolated and special circumstances."[41] This de minimus reliance upon credit made it unlikely that nontraders would suffer serious financial repercussions from a wrongful dishonor. The court noted, however, that modern financial conditions had rendered these premises invalid, since "[t]he vast majority of all modern financial transactions, whether carried on by traders or nontraders, are based upon credit."[42] For this reason, the court held that the presumption of special damages applied in favor of traders also should be applied to nontraders. The court's reasoning in *Witter* is particularly relevant today in light of the pervasive extent to which potential creditors rely upon credit reporting services.

The extension of the trader rule to nontraders can be contrasted with the response to that extension by the commercial and industrial communities which attempted to restrict recoveries from banks for wrongful dishonor. Eighteen states[43] resurrected and enacted a dormant statute, the ABA statute, to govern bank liability for wrongful dishonor. The ABA statute eliminated the trader rule and reinstated the fundamental common law rule of contracts that special damages must be pleaded and proved.

III. The American Banking Association Statute

The wrongful dishonor statute drafted by the American Banking Association in 1914 generally did not contribute lasting stability or predictability to the law of banking transactions. It applied only to a narrow set of circumstances and existed simultaneously with the state's common law. The ABA statute set forth the following rule of wrongful dishonor:

> No bank or trust company doing business in this State shall be liable to a depositor because of the non-payment through mistake or error and without malice of a check which should have been paid unless the depositor shall allege and prove actual damage by reason of such non-payment and in such event the liability shall not exceed the amount of damage so proved.[44]

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[40] *Id.* at 500, 121 P.2d at 418.

[41] *Id.*

[42] *Id. See also* Johnson v. National Bank, 213 S.C. 458, 50 S.E.2d 177 (1948).

[43] *See* note 8 *supra.*

[44] Paton's Digest, *supra* note 8, § 21:B1, at 1117.

Consequently, the ABA statute negated the trader rule by requiring a depositor to prove actual damages arising from a wrongful dishonor. This rule was a direct response to the contention of bank officials that the trader rule took unfair advantage of their position and resulted in liability disproportionate "to the imaginary injury inflicted."[45]

The ABA statute was not comprehensive. While it negated the trader rule by requiring strict proof of actual damages for wrongful dishonor, it failed to consider situations in which wrongful dishonor arose from a bank's "mistake or error." This enabled courts to apply common law principles when presented with a situation not specifically covered by the ABA statute. The resultant judicial freedom produced various approaches in those areas beyond the ambit of the statute's coverage. For example, in wrongful dishonor situations not covered by the statute, it is arguable that plaintiff could state a claim for defamation against the defendant bank. It has been suggested, however, that this approach is unacceptable in states that have adopted the ABA statute. One commentator has contended that the theories behind an action for defamation and the wrongful dishonor provision of the ABA statute make these remedies mutually exclusive.[46] The rationale behind this position is that many defamation claims are actionable per se, while the statute always requires proof of actual damages.

It seems, however, that the ABA statute was generally considered to apply to dishonors caused by bank error alone, rather than to all dishonor situations.[47] Moreover, the adoption of this narrow interpretation precipitated a resort to the common law in situations not expressly governed by the statute. Thus, the adoption of this narrow approach, combined with the difficulty of determining when the statute applied, resulted in an inability to predict the outcome of dishonor cases.

Woody v. National Bank[48] is exemplary of these difficulties. In *Woody* the drawee bank returned a check with the notation "no account." In fact, the plaintiff had maintained an account which contained sufficient funds to cover the check. In his suit against the bank based upon wrongful dishonor, the plaintiff requested $5,000 in compensatory damages and an additional $5,000 of punitive damages despite the fact that the check was for only $6.00. The court sustained the bank's demurrer for failure to

[45] *Id.* at 1118.

[46] Note, *Wrongful Dishonor of a Check: Payor Bank's Liability Under Section 4-402*, 11 B.C. IND. & COMM. L. REV. 116, 120 (1969).

[47] *See* PATON'S DIGEST, *supra* note 8, § 21:B1, at 1117.

[48] 194 N.C. 549, 140 S.E. 150 (1927).

state a cause of action and relied upon the ABA statute, which North Carolina had adopted. The supreme court reversed and chose not to apply the statute. The court held that the dishonor had not occurred through a mistake and decided that a bank statement of "no account" was an intentional act rather than a mistaken act.[49] The ABA statute, therefore, did not apply. The court, indicating that the plaintiff's actual damages provided an additional ground for reversal, stated:

> A complaint is subject to demurrer only when it appears from the facts alleged therein that the nonpayment of the check was through error without malice, and that no actual damages resulted to the depositor from such nonpayment, for in such case the statute is applicable. If the statute is not applicable, the bank may upon well-settled principles be liable to its depositor not only for nominal or actual damages, but also for punitive damages.[50]

Clearly, the ABA statute did not provide a uniform rule applicable to all or most wrongful dishonor situations. It would only prevail in situations of mistaken dishonor, and even then recovery was limited to actual damages. Moreover, the statute provided minimal or no stimulus to establish careful bank operations.

In sum, the ABA statute failed to improve the law and probably added to an already confused jurisprudence.[51] It failed to meet the typical statutory goals of clarity, fairness, unambiguity, and predictability. This same failure foreshadowed yet another attempt to legislate in the area of wrongful dishonor.

IV. Liability for Wrongful Dishonor Under the Uniform Commercial Code

In describing a bank's liability to its customer for wrongful dishonor, the present version of section 4-402 provides:

> A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. When the dishonor occurs through mistake, liability is limited to actual damages proved. If so proximately caused and proved, damages may include damages for an arrest or prosecution of the customer or other consequential damages. Whether any consequential damages

[49] *Id.* at 556, 140 S.E. at 154.

[50] *Id.* at 557, 140 S.E. at 155.

[51] *See, e.g.*, Weaver v. Bank of America, 59 Cal. 2d 428, 380 P.2d 644, 30 Cal. Rptr. 4 (1963); Abramowitz v. Bank of America, 131 Cal. App. 2d 892, 281 P.2d 380 (1955); Woody v. National Bank, 194 N.C. 549, 140 S.E. 150 (1927); Roe v. Best, 120 S.W.2d 819 (Tex. Civ. App. 1938).

are proximately caused by the wrongful dishonor is a question of fact to be determined in each case.[52]

Like the ABA statute, section 4-402 was drafted with the intent to abolish the trader rule by rejecting the conclusive presumption of damages when a businessman suffers from wrongful dishonor.[53] This section, however, is more comprehensive than the ABA statute since it controls all situations of wrongful dishonor, not only those caused by mistake or inadvertence. Section 4-402, unlike the ABA statute, refers to "wrongful" dishonor and impliedly distinguishes between "mistaken" dishonor and "intentional" but still unjustified dishonor. This distinction, although not clearly defined, may be inferred from the section's second sentence which limits recovery in instances of mistaken dishonor to actual damages.

The last two sentences of section 4-402 definitely add something new to possible recoveries for wrongful dishonor. These demonstrate that a bank customer has the right to collect damages caused by his arrest and possible prosecution for passing a "bad" check.[54] Comments to earlier drafts had justified this addition by recognizing that almost all jurisdictions had adopted criminal "bad checks" statutes.[55] Even more significantly, section 4-402, unlike the ABA statute, allows a customer to recover proven consequential damages if proximately caused by a bank's dishonor.[56] The section is in distinct contrast to the common law rule that consequential damages were recoverable if they were reasonably foreseeable at the time a contract was formed.[57]

A plaintiff suing his payor bank under section 4-402 has the burden of proving the bank's knowledge of all consequences actually caused by the dishonor. Meeting this burden may be difficult, since the bank-customer relationship usually is highly im-

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[52] UNIFORM COMMERCIAL CODE § 4-402.

[53] *Id.*, Comment 3.

[54] Various earlier versions of section 4-402 contained a similar provision. UNIFORM COMMERCIAL CODE § 4-402 (1950 version) provided:

> The bank is liable to its customers for any wrongful dishonor of an item, but where the damages occur through mistake the liability is limited to the actual damages proved including damages for any arrest and prosecution.

UNIFORM COMMERCIAL CODE § 4-402 (1952 version) provided:

> A payor bank is liable to its customer for the wrongful dishonor of an item but where the dishonor occurs through mistake its liability is limited to the actual damages proved including damages for any arrest and prosecution of the customer.

[55] *Cf.* UNIFORM COMMERCIAL CODE § 3-417, Comments 3, 4 (1949 version).

[56] See text accompanying notes 10-14 *supra*.

[57] *Cf.* C. MCCORMICK, HANDBOOK OF THE LAW OF DAMAGES § 138 (1st ed. 1935).

personal. For example, a bank normally has minimal, if any, knowledge of the significance of its dishonor upon its customer's credit rating or ability to obtain credit. Except when a bank officer has unique knowledge of a customer's activities, therefore, it could be extremely difficult to impute to a bank anything more than general knowledge of foreseeable injury to its customer.[58]

The difficulties inherent in section 4-402 do not end with plaintiff's burden of proving the *foreseeability* of consequential damages. Doubt also exists concerning the *extent* of recovery allowable under the statute. This problem arises from the second sentence of section 4-402 which states that, in the case of mistaken dishonor, "liability is limited to actual damages proved."[59] This statement is not as clear as it seems on its face. Significantly, a negative implication from the sentence could be inferred so that more than actual damages would be recoverable when a dishonor is *not* due to mistake or inadvertence. Despite the main thrust of the second sentence to restrict damages, the negative implication could extend them.[60]

It is questionable, however, whether this negative implication has been adequately established. The next sentence of the section states that "if so proximately caused and proved, damages may include damages for an arrest or prosecution of customer or *other consequential* damages."[61] Regardless of the nature of the dishonor, therefore, it is arguable that a causal relation must exist between a dishonor and an injury before a customer will be entitled to consequential damages. A further inference also can be drawn from these two sentences. They may be construed to permit actual damages any time there is a dishonor, and, if the requisite causal connection between dishonor and injury exists, the customer has an additional remedy for legitimate consequential damages arising from the dishonor. This interpretation, however, goes beyond that suggested by Professors White and Summers.[62] Moreover, it also reveals a possible inconsistency within section 4-402.

The present language in sentences two and three apparently was a product of concern that prior unenacted drafts of section 4-402, which were silent on the subject of proximate cause, would be interpreted as not requiring a showing of causal connection

[58]The results have been mixed, both in decisions prior to and subsequent to the UCC's enactment. *Compare* Bank of Louisville Royal v. Sims, 435 S.W.2d 57 (Ky. Ct. App. 1968), *with* Skov v. Chase Manhattan Bank, 407 F.2d 1318 (3d Cir. 1969).

[59]UNIFORM COMMERCIAL CODE § 4-402.

[60]WHITE & SUMMERS § 17-4, at 569-70.

[61]UNIFORM COMMERCIAL CODE § 4-402 (emphasis added).

[62]WHITE & SUMMERS § 17-4, at 569-70.

for recovery of damages for arrest or prosecution.[63] In curing this defect, however, other possible interpretive problems have arisen. For example, it is tenable to infer that there is no requirement of proximate cause when actual damages are sought. The New York Law Revision Comments to section 4-402 suggest this problem:

> [The] revision creates further difficulty in the section, since by inserting a specific requirement of proximate cause as to damages for arrest or prosecution it creates a negative inference that the main provision for recovery of "actual damages proved" is not so limited. It was also suggested that a reference to consequential damages generally is needed to overcome the effect of Section 1-106(1), which provides that consequential damages shall not be had except as specifically provided "in this Act or by other rule of law."[64]

While simultaneously approving section 4-402 in principle, the New York Law Revision Commission proposed a revision to overcome this defect.[65] Its revision, however, was not accepted, and the UCC drafters adopted the present version instead.[66] Notably, nothing in the current comments to section 4-402 prohibits recovery of actual damages without proof of proximate cause. Comment 3 only entrenches the statement that actual damages must be proved.[67]

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[63]*See* 1 NEW YORK STATE LAW REVISION COMM'N, 1954 REPORT 318-19, 342, 362 (1954). WHITE & SUMMERS § 17-4, at 570 n.60.

[64]NEW YORK STATE LAW REVISION COMM'N, 1956 REPORT 430 (1956).

[65]*Id.* The suggested revision stated:

> A payor bank is liable to its customer for consequential damages proximately caused by wrongful dishonor of an item, including damages for any arrest or prosecution of the customer so caused, but when dishonor occurs through mistake its liability for consequential damages is limited to the actual damages proved. Whether an arrest or prosecution was proximately caused by wrongful dishonor is a question to be determined upon the facts of each case.

[66]*See* EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, 1956 RECOMMENDATIONS 159 (1957).

[67]UNIFORM COMMERCIAL CODE § 4-402, Comment 3, states:

> This section rejects decisions which have held that where the dishonored item has been drawn by a merchant, trader or fiduciary he is defamed in his business, trade or profession by a reflection on his credit and hence that substantial damages may be awarded on the basis of defamation "per se" without proof that damage has occurred. The merchant, trader and fiduciary are placed on the same footing as any other drawer and in all cases of dishonor by mistake damages recoverable are limited to those actually proved.

The present formulation of section 4-402 may also create confusion in distinguishing between actual damages and consequential damages. The drafters' concern for the need to show proximate cause in arrest-prosecution situations

The difficulties in applying and interpreting section 4-402 are compounded by the cases which have construed it. Courts infrequently have confronted controversies under section 4-402, but the variety of results indicates their confusion and uncertainty regarding its proper interpretation. In particular, the concurrent use of phrases such as "actual damages proved," "consequential," and "proximate cause" have contributed to this confusion, since each of these terms is capable of differing construction.

In *Bank of Louisville Royal v. Sims*,[68] the Kentucky Court of Appeals demonstrated an example of this judicial confusion and found that section 4-402 merely codified prior Kentucky law. In *Sims*, the plaintiff's check was dishonored when the bank placed a ten-day hold on a deposit instead of the normal two-day hold. The plaintiff sought damages of $1.50 for a phone call to the bank, $130 for lost wages, and $500 for injury to his reputation. The court of appeals ultimately reversed the trial court and allowed only $1.50 for the phone call. Significantly, it relied upon *American National Bank v. Morey*,[69] but this reliance was misplaced since the court in *Morey* relied upon decisions that stood for propositions of law bearing little or no relationship to the facts in *Sims*.[70]

In *Sims*, a curious paragraph stands out:

> On authority of *Morey*, the plaintiff was not entitled to recover for her hurt feelings or for her "nerves". It follows, therefore, that she was likewise not entitled to recover for her two weeks' lost time from work even if her mental state actually contributed to this loss. From the proximate cause standpoint, these nebulous items of damage bore no reasonable relationship to the dishonor of her two checks and consequently they could not be classified as "actual damages proved". (Had the action of the bank been willful or malicious, justifying a punitive award, damages of this kind might have been recoverable

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may have produced the result that the nature of available damages is partly determined by the existence or nonexistence of a clearly definable causal relation rather than by the nature of the dishonor. This possible result ignores prior law but is not an appreciable improvement over it. The problem is partly due to the drafters' ambivalence in stating whether recovery for wrongful dishonor is based upon tort or contract theories.

[68]435 S.W.2d 57 (Ky. Ct. App. 1968).

[69]113 Ky. 857, 69 S.W. 759 (1902).

[70]In *Morey* the court failed to distinguish between decisions giving a narrow construction to the trader rule and those extending its presumption to nontraders. *See id.* at 863, 69 S.W. at 759-60. *Compare* Schaffner v. Ehrman, 139 Ill. 109, 28 N.E. 917 (1891), *and* Rolin v. Steward, 139 Eng. Rep. 245 (C.P. 1854), *with* Patterson v. Marine Nat'l Bank, 130 Pa. 419, 18 A. 632 (1889).

> as naturally flowing from this type of tortious misconduct, but we do not have that question here.)[71]

This statement could mean that consequential damages are allowable only for the type of conduct resulting in recovery of punitive damages. That construction, however, would ignore the express language of section 4-402, which states that it is only necessary to show that consequential damages were proximately caused by a bank's dishonor.[72] *Sims* is obviously a mistaken interpretation of section 4-402, therefore, if it is construed to require a punitive damage basis for the recovery of consequential damages. Any other conclusion would simply ignore the plain directions of section 4-402.

Sims may also demonstrate some uncertainty whether recovery should be determined upon the basis of breach of contract or commission of a tort. The court of appeals refused any damages except a $1.50 telephone bill because the plaintiff's voluntary leave of absence from her job and "nerves" reasonably could not have been anticipated from the dishonor. Thus, the court essentially seemed to rely upon a contract theory. The court also stated, however, that if the dishonor had been willful or malicious, damages might have been recoverable as "naturally flowing from this type of tortious misconduct."[73] Recovery seemingly was placed, therefore, upon a threshold level somewhat beyond the actions of the bank in *Sims*.

The difficulty with this approach results from its duality. Sometimes recovery would be justified by breach of contract. In other instances, under slightly different circumstances, a customer would be entitled to recover under a tort theory. Without a consistent standard to apply to bank action in different situations, predictability of results is lost. Obviously, this problem could be avoided by a single theory of recovery.

Three other decisions, *Loucks v. Albuquerque National Bank*,[74] *Skov v. Chase Manhattan Bank*,[75] and *American Fletcher National Bank & Trust Co. v. Flick*,[76] present, at least in some aspects, a more reasoned and appropriate interpretation of section 4-402. *Loucks* represents one of the first cases to interpret section 4-402, and the decisions in *Skov* and *Flick* partially relied upon it. The plaintiffs in *Loucks* consisted of a partnership and its individual partners, Loucks and Martinez. Their bank, in an attempt to

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[71] 435 S.W.2d at 58.

[72] "A payor bank is liable to its customer for damages proximately caused by wrongful dishonor." UNIFORM COMMERCIAL CODE § 4-402.

[73] 435 S.W.2d at 58.

[74] 76 N.M. 735, 418 P.2d 191 (1966).

[75] 407 F.2d 1318 (3d Cir. 1969).

[76] 146 Ind. App. 122, 252 N.E.2d 839 (1969).

collect a prior individual debt of Martinez, charged the partnership account. Its action was protested by both partners without success, and they closed the account by withdrawing the balance of $3.66 remaining after the set-off. Subsequently, the bank dishonored ten checks drawn against the partnership account.

As a result, Loucks and Martinez were limited to cash transactions by some of their suppliers, and certain credit previously granted to the partnership was denied. Loucks also stated that the wrongful dishonor gave him an ulcer which caused further injury to the partnership by the loss of his services. In sum, the plaintiffs sued the bank on behalf of their partnership for damages that included $402 for the wrongful set-off against the partnership account, $5,000 for injury to the partnership's credit, good reputation, and business standing in the community, $1,800 for loss of profits because of Louck's absence caused by his ulcer, and $14,404 as punitive damages. Each partner in an individual capacity sought damages of $5,000 for injury to his personal credit, good reputation, and business standing. In addition, Loucks sought $60,000 for punitive damages and $25,000 for the ulcer allegedly caused him by the dishonor, and Martinez sought $10,000 punitive damages.[77]

The trial court granted $402, the amount of the set-off, but it denied recovery for the other claims. On appeal, the New Mexico Supreme Court held that Loucks was not entitled to damages because he did not come within the UCC definition of "customer."[78] However, the court decided that the trial judge committed error when he removed the question from the jury, since evidence of the partnership's loss of credit had been presented and the injury fell within section 4-402. In respect to the loss of individual credit and the loss of service counts, the court affirmed the dismissal for insufficiency of the evidence since "the partnership had no legally enforceable right to recover for the personal injuries inflicted upon a partner."[79] Moveover, the court upheld dismissal on the issue of punitive damages and reasoned that evidence of intemperate remarks by the bank's vice-president when the plaintiffs closed the account was insufficient to require submitting that issue to the jury.[80]

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[77]76 N.M. at 741, 418 P.2d at 195.

[78]*Id.* at 746, 418 P.2d at 198. The meaning of "customer" was also discussed in Steinbrecher v. Fairfield County Trust Co., 5 Conn. Cir. 393, 255 A.2d 138 (1968), in which it was held that the drafters of the Code did not intend a payee to be a "customer." The question that may follow is "why not?" Certainly a payee might be "any person having an account with a bank." UNIFORM COMMERCIAL CODE § 4-104(e).

[79]76 N.M. at 746, 418 P.2d at 199.

[80]This may be interpreted to permit punitive damages when evidence of

In holding as it did on the right of Loucks to join in the action, the court misapplied both the Uniform Partnership Act (UPA) and the Uniform Commercial Code. The UPA generally accepts that the "aggregate" theory of partnership is merely the sum of the partners. Situations in which an "entity" theory may be used are specifically delineated in the UPA.[81] The UCC, on the other hand, makes no attempt to choose one characterization over another as the form of partnership to be followed . The court erred in assuming that the entity theory was intended to be the only form acceptable under the UCC.

Skov v. Chase Manhattan Bank [82] presented a broader interpretation of consequential damages recoverable under section 4-402. The plaintiff operated a fish shop and sold various types of fish to hotel customers. When a bank erroneously dishonored the plaintiff's check to one of its suppliers, the supplier terminated its relationship with the plaintiff. This made it impossible for the plaintiff to continue to supply his customers with whom he had been doing business for approximately two years. The Court of Appeals for the Third Circuit affirmed an award of damages for three years of anticipated lost profits. The court reasoned that section 4-402's reference to consequential damages "authorized the trial judge . . . to award damages by determining the annual loss of profits to plaintiff from the termination of his relationship with his supplier and to project this loss for a three-year period."[83] After initially determining that section 4-402 is unclear, the court broadly interpreted "consequential damages" to include the possible value of the plaintiff's business had there been no dishonor. Furthermore, the court relied upon *Loucks v. Albuquerque National Bank*[84] and two decisions which spoke to damages in the con-

"malice" or "willfulness" is sufficiently presented. Under common law doctrines, some jurisdictions did permit punitive damages for wrongful dishonor. *See, e.g.*, First Nat'l Bank v. Stewart, 204 Ala. 199, 85 So. 529 (1920); Clark v. McClurg, 215 Cal. 279, 9 P.2d 505 (1932); Hurst v. Southern Ry., 184 Ky. 684, 212 S.W. 461 (1919). In these jurisdictions as well as others allowing punitive damages, the jury is given the discretion to award punitive damages. *E.g.*, McCurdy v. Hughes, 63 N.D. 435, 248 N.W. 512 (1933) (jury refused to award punitive damages when malice was shown). Though at present most courts operating under section 4-402 would, as a matter of law, deny punitive damages, arguments can be made that allowance of them is permissible under section 4-402. *See* Note, *Punitive Damages for Wrongful Dishonor of a Check*, 28 WASH. & LEE L. REV. 357 (1971).

[81] For a more complete discussion of the partnership issue in *Loucks*, see Note, *Right of Partners to Damages for Wrongfully Dishonored Partnership Checks*, 8 NATURAL RESOURCES J. 169 (1968).

[82] 407 F.2d 1318 (3d Cir. 1969).

[83] *Id.* at 1319.

[84] 76 N.M. 735, 418 P.2d 191 (1966).

text of antitrust[85] and unfair trade practices litigation.[86]

American Fletcher National Bank & Trust Co. v. Flick[87] developed an even more expansive construction of section 4-402. In *Flick*, a bank's erroneous set-off of an outstanding loan against a business checking account caused three of the plaintiff's checks to be dishonored. The plaintiff, the operator of a used car business, alleged that his credit and business standing were damaged as a result of the dishonors. He also contended that a resultant loss of income ultimately forced him to close his business. The trial court awarded $18,000 in damages in addition to allowing an improper set-off. The Indiana Court of Appeals reversed the $18,000 damage award only because the plaintiff had failed to prove that a causal connection existed between the dishonors and his alleged business losses.[88]

Rather than narrow the possible scope of recovery under section 4-402, the court of appeals went beyond any prior interpretation:

> Suffice it to say, that insofar as the facts before us require construction of . . . [section] 4-402, we construe it to permit recovery of monetary compensation for *any* actual or consequential harm, loss or injury proximately caused by a wrongful dishonor. . . . We believe in this respect that labels such as "actual" or "consequential" are less than meaningful in the sense of the compensability of harm, injury or loss proximately caused by wrongful dishonor.[89]

Despite Comment 3 to section 4-402,[90] the court also resurrected the trader rule, which specified that credit and business standing are presumptively harmed by a wrongful dishonor. Notably, this presumption was considered to allow recovery of only nominal damages. Further evidence was required to support substantial damages.[91] In sum, *Flick* reflects a favored interpretation of section 4-402. As the Indiana Court of Appeals indicated, the purpose of section 4-402 is to compensate adequately for loss caused by a wrongful dishonor.[92] It is not intended to deprive banks of all protection, but rather to place legal responsibility on the party causing the injury.

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[85]Bigelow v. RKO Radio Pictures, Inc., 327 U.S. 251 (1946).

[86]American Motor Sales Corp. v. Semke, 384 F.2d 192 (10th Cir. 1967).

[87]146 Ind. App. 122, 252 N.E.2d 839 (1969).

[88]*Id.* at 133, 252 N.E.2d at 846.

[89]*Id.* at 132-33, 252 N.E.2d at 845.

[90]See note 67 *supra.*

[91]146 Ind. App. at 134, 252 N.E.2d at 846.

[92]*Id.* at 135, 252 N.E.2d at 847.

A proper interpretation of section 4-402 probably may be derived from *Loucks, Skov,* and *Flick.* In each decision, however, possibilities for misinterpretation and uncertainty still remain. In each, damages were awarded only upon proof that a causal connection existed between the dishonor and the alleged injury. In *Loucks,* for example, the court detailed the various financial difficulties that the plaintiffs encountered after the wrongful dishonor of nine or ten checks. The court then held that the evidence of these financial difficulties "was sufficient to raise a question of fact to be determined by the jury as to whether or not the partnership credit had been damaged as a proximate result of the dishonors."[93] The trial court, therefore, should have submitted the question of proximate cause to the jury.[94] This holding was quoted approvingly in *Skov.* In *Skov,* however, the court recognized potential uncertainty regarding the proper interpretation of section 4-402 and relied upon two decisions awarding damages for anticipated business profits. One of these decisions, *Bigelow v. RKO Radio Pictures, Inc.,*[95] involved a civil action under the Sherman Anti-Trust Act[96] for conspiracy in the maintenance of a system that prevented proper distribution of motion pictures to independent motion picture exhibitors. The Supreme Court affirmed an award of damages which represented a loss of anticipated admission receipts caused by the unlawful conspiracy. *American Motor Sales Corp. v. Semke,*[97] also relied upon in *Skov,* permitted damages for anticipated profits. *Semke* arose out of a breach of franchise agreements between a manufacturer and an automobile dealer. In fact, the liability of the defendant was based upon the Automobile Dealer's Day in Court Act.[98] The Tenth Circuit Court of Appeals refused the contention that the damages recoverable were limited to damages for breach of contract. The court reasoned that "it is clearly established that the

[93]76 N.M. at 746, 418 P.2d at 198.

[94]*Id.* A more recent New Mexico decision concerning the proper damages for wrongful dishonor came to the following conclusion, but only after reviewing all relevant case law: "Plaintiff is entitled to reasonable and temperate damages determined by the sound discretion and dispassionate judgment of the trial court." Allison v. First Nat'l Bank, 85 N.M. 283, 288, 511 P.2d 769, 774 (1973). The case was remanded for a determination of consequential damages, and it seems that such a determination should be based upon the reasons for the dishonor. The court seemed to be following *Sims* by basing the amount of recovery on the type of bank misconduct involved; willful conduct would give rise to a broader recovery than would dishonor by mistake.

[95]327 U.S. 251 (1946).

[96]15 U.S.C. §§ 1 *et seq.* (1970).

[97]384 F.2d 192 (10th Cir. 1967).

[98]15 U.S.C. §§ 1221 *et seq.* (1970).

statute creates a new cause of action and is not merely a new remedy for breach of contract."[99]

Similar recovery in these three cases is not entirely consistent. Some uncertainty remains because the court in *Skov* relied upon decisions which were factually distinguishable when it justified a recovery for lost profits. Moreover, *Skov* failed to indicate why it relied upon antitrust and related doctrines to formulate a basis for recovery under section 4-402. This reliance was not necessarily unwarranted, but the court's failure to justify it further confuses the grounds for recovery under section 4-402.

The court in *Flick* seems correct in having denied more than nominal damages when the plaintiff failed to prove that the wrongful dishonor caused the demise of his business. On the other hand, the court, citing *Loucks*, did construe section 4-402 "to permit recovery of monetary compensation for *any* actual or consequential harm, loss or injury proximately caused by a wrongful dishonor."[100] The court further noted "that labels such as 'actual' or 'consequential' are less than meaningful in the sense of the compensability of harm, injury or loss proximately caused by wrongful dishonor."[101] This interpretation of section 4-402 may have gone too far in two respects. First, in its effort to provide the plaintiff with all possible compensation for damages caused by the dishonor, the court overlooked the distinction between recovery of only "actual damages" and "consequential damages." This oversight can be attributed to the confusion regarding the different meanings to be given these terms as used in section 4-402. Although the court's decision allowing all damages caused by the dishonor is preferable, a more explicit version of section 4-402 would dispel any doubts about the validity of the decision.

Secondly, the *Flick* court might be criticized for resurrecting the old and disavowed trader rule. Although plaintiff Flick showed a causal relation between the dishonor and the collapse of his business, the court still held that damage to credit and business standing would be presumed.[102] It then added that the "primary reason for the recognition of this presumption is that a wrongful dishonor renders the existence of *some* harm to the customer's credit and business standing so probable that it makes legal sense as well as common sense to assume the existence of such harm unless and until the adversary comes forward with some evidence to the contrary."[103] As previously emphasized, the

[99]384 F.2d at 199-200.

[100]146 Ind. App. at 132, 252 N.E.2d at 845.

[101]*Id.*

[102]*Id.*

[103]*Id.* at 133, 252 N.E.2d at 846.

plaintiff in *Flick* failed to show lost income and was permitted to recover only the amount of the check wrongfully dishonored. Reference to the trader rule, therefore, was superfluous. The court was stating that it would have allowed greater monetary damages if the requisite proximate cause had been shown, irrespective of the trader rule. It can only be surmised that the court adopted this reasoning because of its dissatisfaction with the confusing language of section 4-402.

V. The Necessity for a Revised Section 4-402

The overriding confusion attending past and present theories underlying recovery for wrongful dishonor should be apparent. An unambiguous and fresh approach, which is free from unjustified distinctions and misplaced priorities, is essential. Consequently, a revised version of section 4-402 should be adopted with simplicity, economy of language, and internal consistency as its basic guidelines.

Moreover, the new section should implement one single theory of recovery. The Code's present neutrality has allowed courts to apply common law theories with little other guidance. The result has been lack of clarity and specificity regarding the proper amount of damages allowable for wrongful dishonor. Legislation enacted by the states also has failed to establish definite standards for the recovery of damages after a wrongful dishonor.[104]

The new theory of recovery should be a sui generis recovery based primarily upon tort principles. In particular, the new section should establish an independent tort which creates bank liability for all proximate injuries of wrongful dishonor. Damages, therefore, would constitute compensation for injury rather than the benefit of the bargain.[105]

A revised section 4-402 should more explicitly recognize that damage to credit and related injuries are recoverable. This would be consistent with the intent of the Fair Credit Reporting Act[106] to give greater protection to the consumer and would eliminate

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[104]*See* Note, *Wrongful Dishonor of a Check: Payor Bank's Liability Under Section 4-402*, 11 B.C. Ind. & Comm. L. Rev. 116, 126 (1969).

[105]Contract recoveries are unsatisfactory since bank-customer negotiations rarely give the parties notice of any unusual circumstances that might later give rise to special damages. The injuries caused by the bank's wrongful dishonor are those that lie in the subsequent turn of events and, therefore, should not be rejected upon the ground that the parties did not contemplate their occurrence. See note 11 & accompanying text *supra*.

[106]15 U.S.C.A. §§ 1681 *et seq.* (1974). Congress established the Fair Credit Reporting Act to prevent possible abuses in credit reporting. This protection is incomplete. Under section 1681h(e) of the Act, recovery is limited to instances in which "false information [is] furnished with malice or willful intent to injure such consumer." Also, section 1681i sets forth procedures

the distinction between mistaken and intentional dishonor. In short, section 4-402 should emphasize the extent of the injury caused by a dishonor.

Both the ABA statute and section 4-402 were drafted by bank counsel to prevent excessive recoveries against banks.[107] While that objective is not necessarily unjustified, the present form of section 4-402 has the potential to stifle recovery against banks even when actual injury can be shown. Banks seek the efficiency of high speed check processing, while simultaneously insulating themselves from the possible injuries that it may cause. Banks cannot have it both ways. The equities should rest with the party who has been injured, rather than with the party who has proximately caused the injury.

VI. A Proposed Revision of Section 4-402

In view of the compelling reasons for liberalizing a bank customer's right to recover damages upon a wrongful dishonor, the following revision of section 4-402 is proposed:

Section 4-402 Bank's Liability to Customer for Wrongful Dishonor

> A payor bank shall be liable to a customer or person treated in the same manner as a customer by the payor bank for damages proximately caused by the wrongful dishonor of an item. If so proximately caused and proved the payor bank's liability may include, but is not limited to, damage to credit and damages for arrest and prosecution. In all situations where a wrongful dishonor has been proved, recrediting of the account shall be allowed, without any further proof of proximate cause. The determination of what damages have been proximately caused by the wrongful dishonor shall be determined by the trier of fact in each case.

Comments to Proposed Section 4-402

1. This section has been changed. Unlike the previous version, the section now adopts a tort remedy. How-

for correcting reporting errors but lacks any real deterrent for preventing such errors in the first place. For example, a report of a dishonor is made by a bank to a reporting agency, and the agency later passes on the information. If the bank is informed shortly thereafter of its error, it must report it to the agency. *Id.* § 1681h. However, if in the interim the customer has been denied credit or otherwise injured by the report, albeit erroneous, he has no recovery under the Act and currently would be limited to his actual damages under section 4-402.

[107]Apparently both statutes have achieved their goal of precluding large and possibly unjustified recoveries against banks. It is questionable, however, whether such a policy arose from a real need or only from imaginary fears.

ever, it is a new tort with its own elements of recovery. This avoids any confusion with prior tort theories which were sometimes used by courts to fashion a recovery for the customer. The emphasis in the new section is on a causal connection between the dishonor and the injury.

2. Recovery is allowed for loss to credit and loss due to arrest and prosecution. Damages otherwise are those allowable under traditional tort concepts and may include, if appropriate, punitive damages. The common law concept of wrongful dishonor whereby such dishonor is slanderous per se if the check is of one engaged in a business or trade is no longer of any effect.
3. The section allows recovery by a person whose item has *not* been dishonored but who, by nature of his relation to the bank and to the dishonored item, is nevertheless injured by such wrongful dishonor. For example, where a partnership account is charged in order to satisfy an indebtedness of one partner in his individual capacity, the other partner shall be allowed standing in his individual capacity for any damages proximately caused by the wrongful dishonor.
4. "Wrongful dishonor" excludes any permitted or justified dishonor, as where the drawer has no credit extended by the drawee, or where the draft lacks necessary endorsement or is not properly presented.[108]
5. Wrongful dishonor is different from "failure to exercise ordinary care in handling an item," and the measure of damages is that stated in this section, not that stated in section 4-103(5).[109]

The advantages of the revised section can be seen by its application to some of the decisions previously discussed in this Comment. For example, if the proposed section had been utilized in *Loucks v. Albuquerque National Bank*,[110] the plaintiff would have been a "customer" and therefore a proper plaintiff. If the bank had charged the checking account of the partnership because of the outstanding debt of a single partner, it is clear that the bank considered both as a single entity. It would seem fair, therefore, to permit a suit by one or both partners for the wrongful dishonor of checks drawn against the partnership account. The re-

[108]Proposed Comment 4 is verbatim from the second sentence of UNIFORM COMMERCIAL CODE § 4-402, Comment 2.

[109]Proposed Comment 5 is identical to UNIFORM COMMERCIAL CODE § 4-402, Comment 4.

[110]76 N.M. 745, 418 P.2d 191 (1966).

vised section 4-402 would dictate this result by broadening the definition of "customer" to include anyone "understood by the payor bank to be a customer."

The result in *Bank of Louisville Royal v. Sims*[111] would have been reversed under the proposed section 4-402. The court relied upon contract theories of recovery to justify the denial of damages, and the injuries suffered from the dishonor were not deemed to bear a reasonable relation to the dishonor.[112] While it is questionable whether the court's interpretation is consistent with the present language of section 4-402, the proposed revision explicitly refuses to follow contract theories of recovery. If the proposed revision were applied, therefore, the customer in *Sims* would have been permitted to present evidence to establish the causal connection between the alleged injury and the wrongful dishonor.

The decisions in *Skov v. Chase Manhattan Bank*[113] and *American Fletcher National Bank & Trust Co. v. Flick*[114] are consistent with the proposed revision. Both courts gave a sufficiently broad interpretation to "consequential damages" to permit recovery for injuries when a causal connection between the harm and the wrongful dishonor was shown. *Flick* and *Skov* permitted damages for loss of profits and injury to business reputation only if the actual damages were proved. Notably, in both cases the courts expressed their dissatisfaction with the terminology of section 4-402, especially when called upon to construe the phrase "consequential damages."[115]

VII. Conclusion

The creation of an independent tort to govern a bank's liability for wrongful dishonor is the best solution to a problem that has defied traditional legal classifications. Recovery based upon contract principles, with its requisite foreseeability of damages, is peculiarly unsuited to the area because it leads to either limited recovery or no recovery at all.[116] The use of existing tort remedies, especially slander, also has been unsatisfactory.[117]

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[111]435 S.W.2d 57 (Ky. Ct. App. 1968).

[112]See note 67 *supra*.

[113]407 F.2d 1318 (3d Cir. 1969).

[114]146 Ind. App. 122, 252 N.E.2d 839 (1969).

[115]*See, e.g.*, Skov v. Chase Manhattan Bank, 407 F.2d 1318, 1319 (3d Cir. 1969), in which the court stated, "The trial judge properly relied on § 4-402 of the Uniform Commercial Code . . . which is not a model of clarity in its reference to 'damages proximately caused', 'actual damages proved', and 'consequential damages'."

[116]See note 12 & accompanying text *supra*.

[117]See note 15 & accompanying text *supra*.

While the adoption of a presumption of damages after proof of a wrongful dishonor would serve to discipline banks, it would do so unfairly. Such a rule conceivably could permit damage awards beyond the harm actually caused. The more balanced proposed rule would allow a party to recover for all damages which result from a bank's wrongful conduct.

The proposed section 4-402's adoption of an independent tort theory proceeds from the argument that banks have a legal and public duty to avoid the wrongful dishonor of checks.[118] Banks have always encouraged the use of checks, and the public has now come to rely heavily upon them as the virtual equivalent of cash. The present commercial system requires rapid honoring of checks. Since banks have encouraged this system and have profited from checking accounts, equity demands an extension of their liability for all wrongful dishonors. Moreover, because bankers do profit from checking arrangements, they are in a much better position to insure against occasional errors than are their customers.

The adoption of the proposed section 4-402 ultimately could result in greater self-discipline by banks so as to prevent wrongful dishonors. If so, the effect would be fewer recoveries against banks rather than more. The end result could be even greater reliance upon checks and a concomitant benefit to both banks and their customers.[119]

[118] *See, e.g.*, Patterson v. Marine Nat'l Bank, 130 Pa. 419, 18 A. 632 (1889).

[119] *See* Note, *The Measure of Damages for Wrongful Dishonor*, 23 U. CHI. L. REV. 481, 492-93 (1956).

Notes

Administration of the Uniform Consumer Credit Code

I. Introduction

It is axiomatic that no regulatory legislation can be stronger than its enforcement provisions.[1]

The Uniform Consumer Credit Code (UCCC)[2] represents the first comprehensive approach to the legal problems of consumer credit. Responsibility for enforcement of the Code is divided between consumers and an Administrator. However, the greater burden lies with the latter, since not all violations may be corrected by consumer action.[3] Moreover, the consumer's remedies will rarely be used, either because the consumer is unaware of their existence, or because the amount involved is too small to make litigation a practical course.[4] The Administrator, on the other hand, may enforce all Code provisions[5] and has a broad range of authority to collect information necessary to effective enforcement. Thus, while the UCCC does not detract from other remedies available to individuals,[6] the success of the Code in ac-

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[1]Spanogle, *The U3C—It May Look Pretty, But Is It Enforceable?*, 29 Ohio St. L.J. 624 (1968).

[2]Unless otherwise indicated, citations to the Uniform Consumer Credit Code (UCCC) are to the 1969 Official Text with Comments.

[3]Affirmative remedies of individual consumers are found in UCCC §§ 5.202, 5.203. These include actions for the taking of a negotiable instrument in a consumer credit sale, actions to recover amounts paid to a lender who is without authority to make such a loan, actions to recover excess finance charges, actions to recover any refunds due, and actions to recover for past wages due after wrongful discharge. The court has discretion to award attorneys' fees. The individual may also recover for disclosure violations, subject to various defenses. Other remedies are by way of defense only. The individual may not sue to prevent or remedy unconscionable conduct, to prevent unlawful garnishment, or to force the Administrator to take action pursuant to his authority.

[4]*Cf.* Fritz, *Would the Uniform Consumer Credit Code Help the Consumer?*, 25 Bus. Law. 511, 513-18 (1970).

[5]UCCC §§ 6.113, 6.110, 6.104(a). *See also* UCCC § 5.202, Comment 3.

[6]UCCC § 6.115.

complishing its purposes[7] depends on an active, vigorous Administrator.[8]

This Note seeks to ascertain whether the policy decision of the drafters of the UCCC to rely on a "strong administrator" to protect the consumer and to assume an ombudsman role[9] is justified by the manner of enforcement in the states which have adopted the Code.[10] To this end, a questionnaire was designed and presented to the Administrators; responses were received from Colorado, Idaho, Indiana, Utah and Wyoming.[11] The responses to this questionnaire and other information on administration have been evaluated in terms of two previously developed criteria—the orientation and the aggressiveness of the Administrator.[12] This evaluation indicates the effectiveness of the UCCC in general and discloses problems which may be of significance to states contemplating its adoption. The questionnaire itself, along with a composite response, is included as an appendix to this Note.

II. Orientation

An important first step in evaluating the effectiveness or

[7]UCCC § 1.102 states the various purposes of the Code. These include simplifying, clarifying, and modernizing consumer credit, providing rate ceilings, fostering understanding of credit terms and competition among suppliers of consumer credit, protecting consumers from unfair credit practices, encouraging development of fair credit practices, complying with the Federal Consumer Credit Protection Act, and making credit law uniform.

[8]*Cf.* Spanogle, *Why Does the Proposed Uniform Consumer Credit Code Eschew Private Enforcement?*, 23 Bus. Law. 1039 (1968).

[9]National Conference of Commissioners on Uniform State Laws, Report of Special Committee on Retail Installment Sales, Consumer Credit, Small Loans and Usury 37 (1965), *cited in* Spanogle, *The U3C—It May Look Pretty, But Is It Enforceable?*, 29 Ohio St. L.J. 624, 659 n.149 (1968).

[10]To date, the Code has been adopted by Colorado (1971), Idaho (1971), Indiana (1971), Iowa (1974), Kansas (1974), Maine (1975), Oklahoma (1969), Utah (1969), and Wyoming (1971) (effective dates).

[11]The questionnaire was given to the Administrators and deputies at an informal meeting held in Indianapolis, Indiana, on September 18, 1974. Responses were not received from Kansas, Maine or Oklahoma. Iowa did not send a representative. Information on the administration of the Oklahoma UCCC is available in Miller, *Enforcement of the Uniform Consumer Credit Code: Observations from the Oklahoma and Federal Experiences*, 51 N.C.L. Rev. 1229 (1973). Due to the newness of the Code in the remaining states, it is believed that the absence of their responses does not significantly detract from the conclusions reached.

[12]Professor Spanogle has indicated that there are three criteria to be used: adequacy of financing, consumer orientation, and aggressiveness. *See* Spanogle, *The U3C—It May Look Pretty, But Is It Enforceable?*, 29 Ohio St. L.J. 624, 625 (1968). *Cf.* Fritz, *Would the Uniform Consumer Credit Code Help the Consumer?*, 25 Bus. Law. 511, 513-14 (1970). Professor Miller

probable effectiveness of the UCCC as a regulator of consumer credit is to learn who or what agency is in charge of enforcement and interpretation of the Act.[13] In general, the Administrators of the Code fall into two categories, being either a banking[14] or legal[15] officer of the state, or a commission headed by one of these two.[16] Most of the states with longer experience under the UCCC have a bank agency administrator. The selection of one type of administrator or the other suggests the types of administrative enforcement mechanisms preferred in the administration of the Act.

While selecting an elected legal official has immediate political implications, it has been noted that selecting the state's banking officer may also have serious consequences.[17] In the first place, administration of the Code is likely to be but one of several responsibilities of the agency.[18] These other responsibilities may take priority over administration of the Code. Moreover, the qualifications to sit on the administrative commissions generally include experience as a bank executive or bank examiner.[19] Many

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discussed these criteria in his article and found that the second, consumer orientation, was inappropriate, preferring a neutral Administrator. Funding was dismissed as relative. *See also* Miller, *Enforcement of the Uniform Consumer Credit Code: Observations from the Oklahoma and Federal Experiences*, 51 N.C.L. REV. 1229, 1255-57 (1973). The questionnaire revealed no problems with funding. The authors feel that aggressiveness is so closely linked to orientation that the latter is a factor whether or not it is dealt with separately. That is, an Administrator is not likely to vigorously pursue remedies enforcing rights which he believes the consumer does not or should not have. Therefore, orientation has been retained as one indicium of effectiveness.

[13]In the Comment to UCCC § 6.103, the drafters have left complete discretion to the adopting states to select an Administrator.

[14]*E.g.*, Idaho, Indiana, and Wyoming.

[15]*E.g.*, Iowa.

[16]*E.g.*, Colorado, Oklahoma, and Utah.

[17]*See* Fritz, *Would the Uniform Consumer Credit Code Help the Consumer?*, 25 BUS. LAW. 511, 514 (1970).

[18]*E.g.*, the Utah Commissioner of Financial Institutions has jurisdiction over all banks, loan and trust corporations, all building and loan associations, all industrial loan companies, all credit unions, all licensed small loan businesses, and bank service corporations. UTAH CODE ANN. § 7-1-7 (1971 repl.). The problems caused by placing administration of the Code in such an agency were noted in *Symposium—The Uniform Consumer Credit Code and Its Effect on Present Minnesota Law*, 55 MINN. L. REV. 523, 586 (1971). However, no conflicts within the administrative agencies were reported in the questionnaire. *But see* Note, *Utah's UCCC: Boon, Boondoggle, or Just Plain Doggle*, 1972 UTAH L. REV. 133, 152.

[19]IND. CODE § 28-1-2-2 (Burns Supp. 1974) (two out of seven members must represent consumer, agricultural, industrial and commercial interests); KAN. STAT. ANN. § 16-403 (Supp. 1973) (experience with a consumer loan company required); UTAH CODE ANN. § 7-1-1(3) (1971 repl.); WYO. STAT.

of the offices which administer the UCCC were not created by a state's Code or contemporaneously with it but had been in existence[20] and thus approached administration of the Code with conceptions gained from prior experience. Even when the Administrator is a legal official, creditors are given greater opportunity than consumers to influence his action.[21]

Even assuming the utmost integrity on the part of the Administrator, he cannot, in these circumstances, be presumed to be primarily concerned with consumer credit, or to have any orientation thereto which does not comport with his prior duties and loyalties. Because of this, the Administrators chosen to date are not by their experience likely to enforce the Code as the consumer would desire. These persons, who have developed ongoing, working relationships within financial circles, seem unlikely choices to regulate the lending business in the interest of the credit consumer. While the questionnaire does not directly reveal bias on the part of any individual Administrator or of Administrators generally, some of the responses, for example, in regard to staffing, budgeting, and education, indirectly show a lack of consumer orientation as well as a lack of aggressiveness.

III. AGGRESSIVENESS

A. Use of Statutory Remedies

One indicator of the Administrator's effectiveness is his use of the various administrative tools available to him.[22] The Administrator is given the power to bring civil actions.[23] He may seek injunctive relief for violations.[24] He may issue cease and desist orders except in cases of alleged unconscionable conduct.[25] He may in some cases obtain a restraining order.[26] He may accept voluntary assurances of discontinuance of violations.[27] How-

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ANN. § 9-88 (1957). This fact has been cited as an argument for placing greater responsibility for enforcement in the hands of private individuals. *See* Spanogle, *Why Does the Proposed Consumer Credit Code Eschew Private Enforcement?*, 23 BUS. LAW. 1039 (1968).

[20]*See* Appendix, Question No. 4.

[21]*E.g.*, in Colorado, the only interests which are required to be given representation are those of the business and insurance industries. *See* COLO. REV. STAT. ANN. § 73-6-401 (Supp. 1971).

[22]In fact, Professor Miller seems to equate the use of various remedies with aggressiveness. *See* Miller, *Enforcement of the Uniform Consumer Credit Code: Observations from the Oklahoma and Federal Experiences*, 51 N.C.L. REV. 1229, 1256-57 (1973).

[23]UCCC § 6.113.

[24]UCCC §§ 6.110, 6.111 (unconscionable conduct).

[25]UCCC § 6.108.

[26]UCCC § 6.112.

[27]UCCC § 6.109.

ever, all of these procedures are discretionary,[28] and the Administrator cannot be forced to employ any of them.[29] And, in fact, most of these remedies have not been utilized.

Only two states surveyed have used the civil action as an enforcing mechanism.[30] No Administrator has used the power to issue a cease and desist order.[31] Only three state Administrators surveyed have used administrative hearings and investigations.[32] All but one have used assurances of voluntary compliance.[33]

Perhaps this should be viewed as encouraging data, indicating that there are few problems, and that all creditors are being "good guys" and are complying with the Code. Alternatively, the data may indicate unaggressive Administrators who are not seeking out conduct abusive to consumers' rights.

With almost sole enforcement of the Code in a public agency, an aggressive Administrator should bring test cases when the statute is less than clear or silent and should maintain a close watch for areas where violations may be affecting a number of consumers.[34] The failure of several states even to categorize complaints[35] reveals that at least one method of surveillance on behalf of consumers is being ignored.

An overall picture of administration is provided by the staffing of the administrative offices. Few, if any, attorneys are employed by the Administrators to handle legal problems in the office, to interpret the law, or to take action against violators.[36] Often there is no attorney at all. It is difficult to imagine the

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[28]Under the Wisconsin Consumer Act, the Administrator may investigate if he has reason to believe that violations are occurring, and he must investigate upon the filing of five verified complaints of violations of the Act. WIS. STAT. ANN. § 426.106 (1974). *See* Mildenburg, *Powers and Duties of the Administrator Under the Wisconsin Consumer Act*, 49 WIS. BUS. BULL. 53, 54 (1973).

[29]*Cf.* Saucke v. FTC, 333 F. Supp. 1197 (N.D. Ga. 1971) (Consumer Credit Protection Act case).

[30]Appendix, Question No. 16. Cases have generally been settled out of court or resulted in judgments in favor of the Administrator. *See* Miller, *Enforcement of the Uniform Consumer Credit Code: Observations from the Oklahoma and Federal Experiences*, 51 N.C.L. REV. 1229, 1243 n.74, 1258 n.152 (1973).

[31]Appendix, Question No. 16.

[32]*Id.*

[33]*Id.* The seeming readiness to use this procedure is another indication of the direction that administration of the Code has taken.

[34]*Cf.* Spanogle, *Why Does the Proposed Uniform Consumer Credit Code Eschew Private Enforcement?*, 23 BUS. LAW. 1039, 1040 (1968).

[35]Appendix, Question No. 20.

[36]Appendix, Question No. 6. Among the states responding, no full-time attorneys are employed, and no more than one part-time attorney is employed in any state.

Code being effective without a legal staff to implement it. Moreover, there is a serious question in a few states as to whether the Administrator can sue anyone on his own initiative.[37] Although the Code gives the Administrator the authority to hire any necessary attorneys,[38] and to implement the various remedies,[39] these provisions conflict with earlier statutes in at least three states giving the Attorney General the sole right to represent the state[40] or to appoint assistant attorney generals to represent agencies.[41] Though it would seem that the later-adopted Code would control, none of the Administrators involved has yet seen fit to have this matter resolved. Whether or not this causes problems in the day-to-day administration of the Code, it does subject the Code and its Administrators to uncertainty. The influence of the Attorney General is not necessary, nor does it facilitate efficient, aggressive administrative enforcement. The policy considerations of the Attorney General's office are not likely to be the same as those of the Administrator, and the Attorney General's influence may be harmful. In Indiana, at least, the conflict in enforcement runs counter to the expectations of those who studied the uniform draft of the UCCC before its adoption.[42]

It should also be pointed out that since the possibility of consumer class actions is now in doubt,[43] and restrictions have

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[37]Appendix, Question No. 5.

[38]UCCC § 6.104(1)(g).

[39]UCCC § 6.110.

[40]IND. CODE § 4-6-3-1 (Burns 1974); UTAH CODE ANN. § 7-1-24 (1971 repl.); WYO. STAT. ANN. § 9-113 (1959) ("Supervise"). In Kansas, the Attorney General must represent agencies in the supreme court. *See* KAN. STAT. ANN. § 75-702 (1969).

[41]IND. CODE § 4-6-5-1 (Burns 1974); WYO. STAT. ANN. § 9-122 (1959). An Indiana trial court case supports this view. Teachers Credit Union v. Department of Fin. Inst., Civil No. F-9087 (St. Joseph County Cir. Ct., June 22, 1973).

[42]The INDIANA LEGISLATIVE COUNCIL, REPORT OF THE UNIFORM CONSUMER CREDIT CODE STUDY COMMITTEE (1970), stated:

> Part 1 of Article 6 gives the Administrator broad powers to investigate and prosecute UCCC violators through administrative proceedings and civil actions. The sections concerning powers of the administrator such as investigation, enforcement orders, assurances of discontinuance, injunctions and civil actions are permissive, allowing the Administrator to choose the method of enforcement.
>
> The Committee approved the theory of selective prosecution which has the additional advantage of allowing the Administrator to tailor the method and amount of prosecution to the amount of funds and number of personnel available for enforcement.

Id. at 9.

[43]Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974). The lower court opinions are *noted in* 7 IND. L. REV. 361 (1973).

been imposed on legal services organizations,[44] an aggressive Administrator is all the more necessary to protect consumer rights where the extension of credit is involved.[45]

Another possibility to consider in viewing the almost total lack of use of the administrative legal remedies is the restrictive drafting of these sections.[46] However, the Administrators themselves do not appear to view this as a problem since no changes were suggested in the area of remedies.[47] Of course, it is difficult to suggest that a remedy is unworkable or unduly restrictive when it has never been tested.

B. Examination

One of the administrative enforcement powers given to the Administrator by the UCCC is the authority to conduct examinations of both lenders and non-lender creditors falling under his jurisdiction.[48] These powers supplement the power some Administrators have traditionally possessed to examine lenders. However, except in Indiana,[49] examination of non-supervised financial organizations may be done only upon a showing of probable cause to suspect a violation.[50]

Although the Code makes no express preference for this tool, it is apparent that it is the sum and substance of enforcement in some of the adopting states. The questionnaire reveals that examination is the most utilized power of the Administrator.[51] This is largely attributable to the history and orientation of the agencies involved although it appears to also be emphasized in states in which the office of Administrator was created with the adoption of the Code.[52]

This fixation on examination is illustrated by the time spent by UCCC states on examination of banks and other financial in-

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[44]Legal Services Corporation Act of 1974, 42 U.S.C.A. § 2996 (Supp., 1975).

[45]These two factors have been given as underlying justifications for giving the private citizen partial responsibility for enforcing the Code. See Johnson, *Uniform Code for Consumer Credit*, 46 HARV. BUS. REV. 119, 124 (July-Aug. 1968).

[46]*E.g.*, the requirement of probable cause to investigate non-lender creditors, UCCC § 6.106 (not required in Indiana; reasonable cause required in Colorado); a course of unconscionable conduct, UCCC § 6.111(1); or primarily credit transactions, UCCC § 6.111(2)(c).

[47]Appendix, Question No. 22.

[48]UCCC §§ 6.105, 6.106.

[49]IND. CODE § 24-4.5-6-106 (Burns 1974). Colorado requires "reasonable" cause. COLO. REV. STAT. ANN. § 73-6-106 (Supp. 1971).

[50]UCCC § 6.106.

[51]Appendix, Question No. 11.

[52]*Id.*

stitutions under their jurisdiction. Although the National Commisson on Consumer Finance (NCCF) feels that a 2.5 man-day examination is sufficient for each lending office,[53] the UCCC states allot 3.185 man-days to such activities.[54] The states having a banking-agency administrator allot 3.34 man-days per lending branch.[55] Indiana devoted the most time of any in this latter group, using 4.92 man-days per examination.[56]

Examination to the extent outlined above obviously takes manpower and budgetary resources away from other types of enforcement. Moreover, it is questionable whether the purposes of examination are the same as those of consumer credit protection. According to the NCCF, the primary concern of examination is the solvency of the institution examined.[57] In addition, state examinations of banking institutions duplicate federal examinations to a large extent, thus making the waste of resources greater.[58]

This emphasis on examination was not anticipated by the drafters of the Code. Rather, it was envisioned that little time would be devoted to such activities, and that relative simplicity of examination would allow the Administrator to implement the other Article VI provisions.[59] Moreover, it is apparent that some of the Administrators have neglected the substance of enforcement in favor of the appearance of enforcement given by examination of banks and businesses and the contribution of fees derived therefrom into the state's general fund.[60] These facts weigh heavily against placing enforcement of the Code in the hands of the state's banking commission.

C. Consumer Education

The Administrator is given power to counsel individuals and groups on their rights and duties under the Code, and to establish programs for consumer education on credit practices and

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[53]NATIONAL COMM'N ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 56 (1972).

[54]*Id.*, Exhibit 4-9, at 78-79.

[55]*Id.* No data was given for Idaho.

[56]*Id.* Kansas was high for all states with 5.11 man-days per office.

[57]*Id.* at 53. *Cf.* UTAH CODE ANN. § 7-1-8 (1971 repl.).

[58]NATIONAL COMM'N ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 53-54 (1972).

[59]*See* Curran, *Administration and Enforcement Under the Uniform Consumer Credit Code*, 33 LAW & CONTEMP. PROB. 737 (1968); Dunham, *Unconscionable Conduct and the Uniform Consumer Credit Code*, 23 J. FIN. 312, 319 (1968). *See also* INDIANA LEGISLATIVE COUNCIL, REPORT OF THE UNIFORM CONSUMER CREDIT CODE STUDY COMMITTEE 9 (1970).

[60]UCCC § 6.203 provides for notification and filing fees which, in Indiana, go in part to the state's general fund.

problems.[61] It is clear that since much of the enforcement of the Code is in the hands of the Administrator, the consumer must be made aware that an agency is there to help him with his consumer credit problems.[62] A highly visible agency is an absolute necessity to effective public enforcement of the Code. Since the Administrator has the power to receive complaints, and to act upon them,[63] the individual consumer must be made aware of where and how to register his complaints.

How are the states communicating with the consumer? No state reported the use of a Wide Area Telephone Communications Service line for the registration of complaints. Only one state surveyed has used professional television spots, and two have used radio spots to reach the consumer.[64] It is discouraging that the mass media has not been more utilized since it is undoubtedly the most effective method of reaching large numbers of consumers.

Pamphlets and lectures are being used as a method of educating the consumer in some states;[65] however, at best, these will primarily reach the more well-informed citizens. In two states, limited attempts have been made to reach high school audiences.[66] There is no indication that any overall programs of consumer education are in existence or planned in any state surveyed.[67]

The power to receive complaints should enable the Administrator to discover the particular areas in which consumer credit problems need attention and education. Educational programs could be partially channeled in these directions, but at least two states do not have data to categorize complaints, making an analysis along these lines mere guesswork.[68] Since all but one state reported a formal method of making complaints,[69] the information to categorize complaints is available and should be used in determining areas needed for consumer education.

The Administrator is also given power to make studies in order to effectuate the purposes and policies of the Code.[70] No

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[61]UCCC § 6.104(1).

[62]See Caplovitz, *Consumer Problems*, 23 LEGAL AID BRIEF CASE, 143, 147 (Feb. 1965).

[63]UCCC § 6.104(1).

[64]Appendix, Question No. 7. The Federal Trade Commission has used such spots but no assessment of effectiveness has been made. *See* Feldman, *FTC Enforcement of the Truth In Lending Act—One Year Later*, 26 BUS. LAW. 835, 837-38 (1971).

[65]Appendix, Question No. 7.

[66]*Id.*

[67]*Id.*

[68]Appendix, Question No. 20.

[69]Appendix, Question No. 18.

[70]UCCC § 6.104(1)(d).

state surveyed reported any studies undertaken.[71] A study of consumer awareness of the existence of consumer credit legislation would be helpful in planning consumer education. Most creditors will at least be aware of the Code because of the notification filing requirements. On the other hand, consumer awareness depends upon effective education programs originating with the Administrator.

IV. Conclusion

The effectiveness of the Uniform Consumer Credit Code as a regulator of consumer credit depends largely upon the Administrator. The history and staffing of the current Administrators yield a structure which is not conducive to effective enforcement. This raises the question of whether states considering adoption of the UCCC in the future would find it more advantageous to adopt other consumer credit acts or simply to revise existing laws. At least, greater consideration should be given to the qualifications and selection of the Administrator and the structure of his office.

While no statute can insure that the agency entrusted with enforcement will adequately protect consumer interests, such purpose would be advanced by placing the administration of the Code in the hands of a separate agency, or an agency with a parallel constitutency. Certainly any such agency should have an adequate legal staff and the Administrator should possess the authority to sue suspected violators on his own initiative. Some actions should perhaps be made mandatory, as in the Wisconsin Consumer Act.[72] Finally, someone with appropriate training should be placed in charge of developing an overall program of consumer education both for adults and children.

None of these things, either singly or collectively will insure enforcement of consumer credit protection, but each would greatly improve the administration of the Uniform Consumer Credit Code relative to the manner of enforcement to date.

Baker R. Rector
Susanne B. Jones

[71] Appendix, Question No. 7.
[72] Wis. Stat. Ann. § 426.106 (1974). See note 28 *supra*.

Appendix*

1. *How are registration fees assessed in your state? How much revenue is raised in this manner?*

Colorado: Supervised lenders—$150 per office
Supervised Financial Organizations—$10 per location
All others—$10 per $100,000
Revenue raised: approximately $165,000 per year

Idaho: Statutorily Authorized Fee—Maximum $50 Notification Fee plus $10 for each $100,000 of volume of consumer credit transactions over $100,000
Fee for Fiscal 1972—$25 plus volume fee
Fee for Fiscal 1973—$15 plus volume fee if the creditor charges interest; $10 plus volume fee if the creditor does not charge interest
Fee for Fiscal 1974—$15 plus volume fee if the creditor charges interest; $10 plus volume fee if the creditor does not charge interest
Revenue raised: Fiscal 1972—$100,441
Fiscal 1973—$ 74,580
Fiscal 1974—$ 87,236

Indiana: Fee when filing Notice of Intent—$15
$15 per first $100,000 of "original unpaid balances" or part thereof
$10 per each $100,000 or part thereof above the first $100,000
Revenue raised: approximately $450,000 per year

Utah: Regulated Lenders, including non-lending sellers—basic fee of $25 on or before January 1st of each year, plus $10 for each $100,000, or part thereof, in excess of $100,000, of the original unpaid balances arising from consumer credit transactions made within the preceding year and held for more than 30 days
Supervised Lenders—pay the above fees on the same date, but are required to pay an additional $25 basic fee plus $25 for each additional location on July 1st of each year
Assignees—$10 on the first $100,000 of volume of assigned transactions
Revenue raised:

Regulated lenders and non-lending sellers	$81,140
Supervised Lenders	$13,983
Total	$95,123
Examination fees for Supervised Lenders	$ 8,580

Wyoming: $10 minimum per year plus $15 per $100,000 or portion thereof for each $100,000 of volume in excess of the first $100,000
Revenue raised: $50,000 annually

*The answers from the Administrators are for the most part taken verbatim from the questionnaires. Minor changes have been made by the authors for clarity.

2. *How much does your state allocate for operation of the Administrator?*

Colorado:	1974-75	$134,000
	Requested 1975-76	$160,000
Idaho:	1974	$87,236
Indiana:	Information not available at present	
Utah:	Estimate for fiscal year ending June 30, 1974	$73,428
Wyoming:	Current biennium	$93,000

3. *Approximately, what percent of businesses required to be registered under the U3C are, in fact, registered?*

Colorado:	85%
Idaho:	92%
Indiana:	No data available
Utah:	80%
Wyoming:	80%

4. *Administration. Is your agency new with the U3C, or was it in existence prior to that time?*

Colorado:	New
Idaho:	In existence
Indiana:	Created in 1935
Utah:	Department in existence, but consumer credit administration was new when act became effective
Wyoming:	New

5. *Can you sue suspected violators on your own initiative, or must you obtain the consent or assistance of another person or agency?*

Colorado:	On own initiative
Idaho:	On own initiative
Indiana:	My understanding is we would need to do so via the Attorney General's office; we can issue certain orders, but not actually sue.
Utah:	Attorney General sues on behalf of the Administrator.
Wyoming:	No response to this question

6. *How many attorneys are employed for U3C work?*

Colorado:	One, but part of the Attorney General's office
Idaho:	None
Indiana:	None "officially", one "unofficially"
Utah:	One (part time), none at present
Wyoming:	One (part time)

7. *What education, study, and publicity programs have been undertaken by you, and what percent of your overall budget is allocated to these functions?*

Colorado:	Pamphlets, three 30 second professional television spots, three 30 second professional radio spots, placards for buses Percent of overall budget: Up to 10%
Idaho:	Lectures at schools, community service organizations, business groups and consumer groups Percent of overall budget: 10%
Indiana:	Such activities have been spasmodic and meager. Such is an un-met need. Percent of overall budget: No percentage specifically allocated

Utah: Two brochures have been developed for consumer education. Appearances on television consumer programs and radio spots. Talks to many high schools in the State. Appearances on programs sponsored by minority groups and special interests such as home economic, legal and accounting conventions.
Percent of overall budget: Less than 1%

Wyoming: No full time program developed. Have prepared audio-visual presentations (consumer and creditor) which are presented upon request. Also disseminated pamphlet throughout State for consumer education.
Percent of overall budget: 5%

8. *Examinations. Are examinations made of all, or virtually all, consumer credit transactions of supervised financial institutions under your jurisdiction, or are random samples taken? That is, to what extent do you find discretion in examination to be advantageous?*

Colorado: Random samplings of approximately 20% unless past history of violations—then could be as high as 100%.

Idaho: Samples are taken initially. If there is a 5% of sample error factor all transactions are reviewed.

Indiana: Discretion in this Division is necessary. We assign our non-lender examinations by our discretionary judgments. Most "supervised financial organizations" are not fully examined for U3C compliance.

Utah: Spot check of credit files is made initially. If numerous violations are found, a more complete examination is made.

Wyoming: At the outset virtually all transactions are checked, but currently, in routine re-examinations, random samples are taken. If sampling indicates repeated violations then extensive checking is pursued.

9. *At what intervals do examinations occur?*

Colorado: Supervised Lenders—at least once per year. If a problem, then three times.
All others—occasional basis

Idaho: Annually

Indiana: From 12 to 18 months as discretion suggests need, and staff is available.

Utah: Supervised Lenders—annually
Regulated Lenders and non-lender sellers—as complaints require or as the department becomes aware of irregularities, or at the discretion of the Administrator.

Wyoming: State chartered supervised financial organizations—semi-annually
State licensed supervised lenders and sales finance companies—annually

10. *What is the status of nationally chartered institutions under your scheme of administration?*

Colorado: No right to examine, but work through Regional Adminstrator of National Banks.

Idaho: Each office is licensed separately.

Indiana: They pay Code fees but are not examined by us for compliance.

Utah: Any institution chartered or holding authorization certificate under this State or the United States to make loans and to receive deposits, including savings, shares, certificate or deposit accounts, is exempt from filing notification.

Wyoming: Agency designed examination check lists used by examiners of federally chartered Supervised Financial Organizations.

11. *What emphasis do you place on examination, relative to the other powers granted to you by the Code?*

Colorado: Most emphasis on examination

Idaho: It is the most time consuming single function.

Indiana: Examination is paramount. Some consumer creditors don't know anything regarding requirements. Others are aware but poorly informed. Examinations are not only curative but preventative.

Utah: Examination forms are furnished National Bank Examiners for their use in examining federally chartered banks. Examination of Regulated Lenders may be made without cause at the discretion of the Administrator.

Wyoming: Considerable emphasis is placed on examinations. Creditors are normally appreciative of assistance rendered in gaining compliance. Unless it appears there is no other recourse only then would other powers granted be invoked.

12. *How many examiners do you employ to examine (a) financial institutions, (b) credit retailers, or (c) undifferentiated examiners?*

Colorado: (a) 1 chief examiner, 3 regular examiners

Idaho: The UCCC Bureau is allocated 1.7 examiners who examine financial institutions and retailers.

Indiana: This Division: 17 [Authors' note: "This division" probably means Division of Consumer Credit, which is one of four divisions of the Department of Financial Institutions.]

Utah: (a) 3 (b) 1 (c) 12

Wyoming: (a) one agency examiner, six bank examiners
(b) retailers not examined but investigated upon receipt of probable cause
(c) no undifferentiated examiners

13. *What inter-departmental problems or conflicts have arisen in the administration of the U3C in your state?*

Colorado: None

Idaho: None

Indiana: I must refer you to the Director since my responsibility is limited to the position of Supervisor of the Division of Consumer Credit, charged by statute with administering the law.

Utah: None. In fact the U3C being administered within the department helps the Administrator to enforce the statutes governing consumer credit transactions more

expeditiously than if the U3C was administered alone or in another department.

Wyoming: No response to question

14. *To whom may we write to obtain copies of your annual reports to the Governor, exam sheets for financial institutions, or other similar papers?*

Colorado: Administrator UCCC
112 East 14th Avenue
Denver, Colorado 80203

Idaho: Idaho Department of Finance
Statehouse Annex 5
Boise, Idaho 83720

Indiana: Joseph V. Riley, Supervisor
Division of Consumer Credit
1024 State Office Building
Indianapolis, Indiana 46204

Utah: Department of Financial Institutions
Ten West Broadway—Suite 331
Salt Lake City, Utah 84101

Wyoming: State Examiner, Administrator, Wyoming UCCC
Supreme Court Building
Cheyenne, Wyoming 82002

15. *What have been your major administrative problems under your version of the Code?*

Colorado: Collection of fees

Idaho: Inadequate staff

Indiana: (1) Interpreting the meaning of the law to creditors and attorneys.
(2) Resistance by consumer creditors who haven't known of the law or resent its requirements.

Utah: Registration of non-lender sellers.
FTC Rule Making Authority versus States Statutes of U3C.
Closing costs on loans secured by an interest in land in which the annual percentage rate exceeds 10%.
Arranger of credit needs definition.
To establish minimum of 12% APR on which real estate transactions would be subject to the Code as consumer loans.

Wyoming: Rounding up creditors required to file notification.
Transactions assigned to out-of-state assignees.
Gaining compliance by itinerant door-to-door credit sellers.

16. *We need to know something of the legal remedies employed by you. Therefore, we would like to know how many of the following actions have been employed, and to what extent. Second, what importance the remedy assumes relative to other methods of enforcement. Third, for what types of violations are the remedies used. Finally, what problems arise in the use of each action. Civil Actions, Criminal Actions, Administrative Hearings and Investigations, Cease and Desist Orders, Assurances of Voluntary Compliance.*

Colorado: Civil Actions: None
Criminal Actions: None

Administrative Hearings and Investigations: Numerous Investigations, Fourteen Hearings
Ceases and Desist Orders: None
Assurances of Voluntary Compliance: Two

Idaho: Civil Actions: None
Criminal Actions: None
Administrative Hearings and Investigations: 400
Cease and Desist Orders: None
Assurances of Voluntary Compliance: None

Indiana: Civil Actions: None have been initiated
Criminal Actions: None have been initiated. Such we believe must be via the County Prosecutor.
Administrative Hearings and Investigations: No hearings, except for Regulations. Many field investigations have been made with varying effect, mostly successful.
Cease and Desist Orders: None have been issued
Assurances of Voluntary Compliance: Hundreds via examination and special field examinations

Utah: Civil Actions: 7 suits brought by the Attorney General on behalf of the Administrator. All settled by stipulation. Violations consisted of fraudulent misrepresentations having the effect of coercing and inducing consumers to purchase; misleading material used, literature, sales ads and letters; full disclosure under the act was not made.
Criminal Actions: None
Administrative Hearings and Investigations: 7 hearings have been held by the Administrator. 2 hearings held for failure and refusal to file notification. Both complied and have continued to renew filing. 2 hearings on disclosure violations. Both complied with corrected forms. 1 hearing on improper advertising was settled by acceptance of consent order. 1 hearing on probable requirement of credit life insurance on contracts. Determined to be a misunderstanding on the part of the consumer. 1 hearing on referral sales was found to be without cause and no violation found.
Cease and Desist Orders: None
Assurances of Voluntary Compliance: Two accepted without hearing

Wyoming: Civil Actions: None
Criminal Actions: None
Administrative Hearings and Investigations: None
Cease and Desist Orders: None
Assurances of Voluntary Compliance: 25

17. *What special tactics, if any, may be used against a business about which repeated complaints have been made?*

Colorado: None

Idaho: No response to question

Indiana: We have very few of such. Most want to comply. We persuade, cajole, sometimes compromise, and finally imply the possibility of legal action.

Utah: Commence an investigation if there is probable cause to believe a violation has occurred. After notice and hear-

ing, issue cease and desist order. The Administrator may bring a civil action to restrain a person from violating the act.

Wyoming: Reference Section 40-6-106, Wyoming Statutes.

18. *Do you have a formal channel through which consumer complaints are transmitted? Is a copy of any investigative report sent to the complaining consumer?*

Colorado: Formal complaints filed in office or through Colorado State University Extension Service. Consumer receives a written reply but not a copy of the report.

Idaho: (a) yes (b) no

Indiana: (a) yes (b) Not as practice; but we advise him of results effected.

Utah: (a) No formal channel on consumer complaints is used. Some are made by telephone; others by personal contact at the department by completion of a complaint form.
(b) We sometimes send a copy of an investigative report to the complainant.

Wyoming: (a) yes (b) no

19. *Have any applications for licenses been refused, or outstanding licenses revoked or suspended?*

Colorado: Three refused for insufficient capital.
Twelve revoked for failing to file reports or out of business without surrender of permanent license.

Idaho: No

Indiana: Not under the U3C

Utah: No

Wyoming: One license refused

20. *What are the major types of complaints made or issues raised by consumers, businessmen, or lenders, either formally or informally?*

Colorado: Consumers—rebates
Lenders etc.—Code too severe

Idaho: Consumers—rates and rebates
Business—rates and disclosure

Indiana: Consumers are the complainants. We do not have data that would categorize complaints; they run a broad gamut.
"Small businesses" complain bitterly about the onerous burden of filing and paying a fee. (Refer to Question 22 for a remedy.) Large business endorsed the Code and generally have influences in the legislature for changes they desire.

Utah: By consumers: overcharges, homes solicitation sales, disclosure violations, rebate quotations.
By businessmen: notification filing, compliance with Federal and State laws which are not uniform.
By lenders: changes requiring printing of new forms, confusion on closing costs and some rebate transactions.

Wyoming: Unable to categorize

21. *If a violation of the U3C is found or suspected, what do you consider to be the most effective means of remedying the problem, assuming voluntary compliance is not forthcoming?*

Colorado: Administrative hearing

Idaho: 1. Suit for injunction 2. Administrative license revocation

Indiana: As a first step: Administrative Hearing. Much would depend on the severity of the violation.

Utah: Cease and desist order with civil action to restrain violations of the act.

Wyoming: To date no problems in obtaining statement of voluntary compliance. Would assume, in the absence of previous experience, that provisions of Section 40-6-108 would be most effective.

22. *Do you consider any modifications of the Uniform Draft to have been beneficial from the standpoint of administration? What modifications would you recommend to states who enact the Code in the future?*

Colorado: Require license fee from Supervised Lenders
Prohibit Rule of 78's after 60 months
Prohibit unilateral deferral
Possible removal of brick wall amendment

Idaho: I would recommend that Administrators request that notification fees be paid into a dedicated fund so that the fees may actually be used to administer the Code. The common practice is for the funds to be paid into the state general fund with only a part of the funds subsequently being appropriated to the administrator.

Indiana: (a) Elimination of Department requirement that gasoline filling stations must file.

(b) Generally, I favor: 1. Eliminate "month for-a-day" on prepayment. Go to nearest due-date. 2. Revise formula for fees. Assess administrative costs on "creditors" who benefit most via volume and profit-participation. Save the little businessman from fees and the Division from mass details thereby. 3. Stipulate willfull failure to "file" as grounds for voiding consumer loan or consumer credit sale.

Utah: Administrative Rules of the Administrator should supersede any provisions of the act which are inconsistent with the Federal Consumer Credit Protection Act.

Wyoming: It is hoped that, in the interest of uniformity, no major changes will be made by States enacting the Code in the future. Already the "uniform" Code has been stretched beyond recognition and discussions among the various administrators, in which mutual problems may be discussed, is becoming increasingly difficult.

The Consumer Product Safety Act: Risk Classification and Products Liability

I. Introduction

The Consumer Product Safety Act[1] has consolidated and enlarged federal involvement in regulating the safety of consumer products.[2] The Consumer Product Safety Commission, an independent regulatory commission created by the Act,[3] is the focus of voluminous information on defective products, consumer injuries, recall campaigns, and design modifications. This information enables the Commission to determine which consumer products pose unreasonable, imminent, or substantial risks of injury and to take appropriate action under the Act against such products and their suppliers. This same data and the Commission's action thereon is available to the resourceful plaintiff who has been injured by a consumer product and can be of significant value to him in proving liability under theories of negligence or strict liability. This Note will explore the several product risk classifications available to the Commission, the data it may re-

[1] 15 U.S.C. §§ 2051-81 (Supp. III, 1973) [hereinafter referred to as the Act]. Comprehensive background information on the Act can be found in The Consumer Product Safety Act (Bureau of National Affairs ed. 1973). A leading discussion of the procedural aspects of the Act can be found in Scalia & Goodman, *Procedural Aspects of the Consumer Product Safety Act*, 20 U.C.L.A.L. Rev. 899 (1973). Reviews of the Act and discussions of its consumer protection potential can be found in Note, *The Consumer Product Safety Act: Bold New Approaches to Regulatory Theory*, 5 Loy. L.J. 447 (1974); Note, *The Consumer Product Safety Act—Front-End Protection for the Consumer Creates an Increased Burden of Care for the Consumer Product Industry*, 3 Memphis St. U.L. Rev. 344 (1973); Note, *The Consumer Product Safety Act—A Federal Commitment to Product Safety*, 48 St. John's L. Rev. 126 (1973); Note, *The Consumer Product Safety Act—Placebo or Panacea?*, 10 San Diego L. Rev. 814 (1973).

[2] 15 U.S.C. § 2079 (Supp. III, 1973) transfers to the Consumer Product Safety Commission the administration of: (1) The Federal Hazardous Substances Act, *id.* §§ 1261-74 (1970); (2) The Poison Prevention Packaging Act of 1970, *id.* §§ 1471-76; (3) The Flammable Fabrics Act, *id.* §§ 1191-1204; and (4) The Refrigerator Safety Act, *id* §§ 1211-14. The scope of the Commission's authority was later extended to include the Child Protection and Toy Safety Act of 1969, *id* §§ 1261-62, -74. For a study of the scope and adequacy of federal safety legislation, see Federal Consumer Safety Legislation, A Study of the Scope and Adequacy of the Automobile Safety, Flammable Fabrics, Toys, and Hazardous Substances Programs (June, 1970) (a special report prepared under the direction of H.A. Heffron for the National Comm'n on Product Safety).

[3] 15 U.S.C. § 2053 (Supp. III, 1973) [hereinafter referred to as the Commission].

quire in the determination of those risks, and the value of this data to an injured consumer plaintiff.

II. History

The National Commission on Product Safety (NCPS) was created in 1967 at the direction of President Johnson and the Congress to "conduct a comprehensive study and investigation of the scope and adequacy of measures now employed to protect consumers against unreasonable risk of injuries which may be caused by hazardous household products."[4] The Commission concluded:

> Americans—20 million of them—are injured each year in the home as a result of incidents connected with consumer products. Of the total, 110,000 are permanently disabled and 30,000 are killed. A significant number could have been spared if more attention had been paid to hazard reduction.[5]

The solution proposed by the NCPS to this serious problem, after it found existing federal and state laws inadequate, was the Consumer Product Safety Act. The Act created the Consumer Product Safety Commission, consisting of five members, and vested in the Commission regulatory authority over all consumer products.[6] In the exercise of its authority, the Commission may promulgate and enforce consumer product safety standards,[7] collect and analyze data on injuries associated with con-

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[4]81 Stat. 466 (1967).

[5]National Comm'n on Product Safety, Final Report Presented to the President and Congress 1 (1970) (footnote omitted) [hereinafter cited as NCPS].

[6]15 U.S.C. § 2052(a)(1) (Supp. III, 1973) provides:

> The term "consumer product" means any article, or component part thereof, produced or distributed (i) for sale to a consumer for use in or around a permanent or temporary household or residence, a school, in recreation, or otherwise, or (ii) for the personal use, consumption or enjoyment of a consumer in or around a permanent or temporary household or residence, a school, in recreation, or otherwise . . . .

Excluded from the meaning of the term "consumer product" are articles not customarily produced for use by consumers, tobacco and tobacco products, motor vehicles, economic poisons, aircraft or aircraft components, boats, drugs, medical devices, cosmetics, and food. *Id.* § 2052(a)(1)(ii)(A) to (I).

[7]These consumer product safety standards are to consist of one or more of the following kinds of requirements:

> (1) Requirements as to performance, composition, contents, design, construction, finish, or packaging of a consumer product.
>
> (2) Requirements that a consumer product be marked with or accompanied by clear and adequate warnings or instructions, or requirements respecting the form of warnings or instructions.

Any requirement of such a standard shall be reasonably necessary

sumer products,[8] and promote research on the causes and prevention of injuries connected with consumer products.[9] In addition, when a consumer product falls into one of the following three risk classifications, the Commission may take a wide range of specific actions against the product and its suppliers.

First, whenever the Commission finds that a consumer product presents an unreasonable risk of injury from which the public cannot be protected by a feasible safety standard, that product may be declared a banned hazardous product.[10] Secondly, the Commission may seek an injunction allowing it to seize or require recall of a product which presents more than just an unreasonable risk of injury, namely, a product which presents an imminent and unreasonable risk of death, serious illness, or severe

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to prevent or reduce an *unreasonable risk of injury* associated with such product. The requirements of such a standard (other than requirements relating to labeling, warnings, or instructions) shall, whenever feasible, be expressed in terms of performance requirements.

Id. § 2056(a) (emphasis added).

[8] *Id.* § 2054(a)(1).

[9] *Id.* § 2054(b).

[10] *Id.* § 2057 provides:

Whenever the Commission finds that—

(1) a consumer product is being, or will be, distributed in commerce and such consumer product presents an unreasonable risk of injury; and

(2) no feasible consumer product safety standard under this chapter would adequately protect the public from the unreasonable risk of injury associated with such product, the Commission may propose and, in accordance with section 2058 of this title, promulgate a rule declaring such product a banned hazardous product.

In a recent decision, Tuchinsky v. Consumer Prod. Safety Comm'n, Civil No. 219-73 (D.D.C., Nov. 14, 1974), the plaintiff sought to compel the Commission to commence rule-making procedures to establish standards and criteria for determining what children's mechanical toys pose an unreasonable risk of personal injury pursuant to the Child Protection and Toy Safety Act of 1969, 15 U.S.C. §§ 1261-62, -74 (1970). See note 2 *supra*. While it was not disputed that the Commission could proceed on a toy-by-toy basis, the court concluded that the agency is under an obligation to attempt to promulgate general prescriptive regulations which would give broad notice to toy manufacturers and consumers of the types of toys that are hazardous. The import of this holding on the operation of the above quoted parallel provision of the Consumer Product Safety Act which empowers the Commission to declare a consumer product a banned hazardous product is that the Commission may be barred from banning a product unless it can persuade the court that it was impossible to promulgate general prescriptive safety regulations governing the particular hazard. The Commission subsequently published, in January 1975, regulations "establishing test methods to simulate the normal and reasonably foreseeable use, damage, or abuse to which toys, games, and other articles intended for use by children may be subjected." 40 Fed. Reg. 1480 (1975).

personal injury.[11] Thirdly, upon finding that a product creates a substantial product hazard, the Commission may direct a manufacturer, distributor, or retailer to notify purchasers and to repair, replace, recall, or refund the purchase price of the product.[12]

This Note will explore the parameters and the evidentiary implications of these risk classifications. Their significance is that a consumer product must be classified into one of them before specific action can be taken against the product or its supplier. A Commission finding that a product presents an unreasonable, imminent, or substantial hazard not only alerts the supplier that his product may be defective, but also signals counsel representing a consumer injured by one of these products that there likely exists a compilation of statistical and historical data on the product's deficiencies which will be valuable to him in proving liability.

III. Risk Classifications

A. Unreasonable Risk of Injury

The fundamental purpose of the Act is to protect consumers against unreasonable risk of injury from hazardous products. A product which poses an unreasonable risk of injury is one which is dangerous beyond the extent which would be contemplated by an ordinary consumer.[13] The challenge presented to the Commission is to differentiate between products whose risks of injury are reasonable and those whose risks are unreasonable. Congress suggested that the determination of an unreasonable risk take into account the following considerations:

1. the degree of the anticipated injury;

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[11]15 U.S.C. § 2061(a) (Supp. III, 1973) provides:

> The Commission may file in a United States District Court an action (1) against an imminently hazardous consumer product for seizure of such product under subsection (b)(2) of this section, or (2) against any person who is a manufacturer, distributor, or retailer of such product, or (3) against both. Such an action may be filed notwithstanding the existence of a consumer product safety rule applicable to such product, or the pendency of any administrative or judicial proceedings under any other provision of this chapter.

[12]*Id.* § 2064(d).

[13]Dreisonstok v. Volkswagenwerk, A.G., 489 F.2d 1066, 1072 n.19 (4th Cir. 1974); Greeno v. Clark Equipment Co., 237 F. Supp. 427 (N.D. Ind. 1965). "It is not negligent for one to manufacture and sell an axe or power saw because the dangers are obvious and the manufacturer can reasonably expect others in the exercise of ordinary prudence to perceive and appreciate the dangers." *Id.* at 430. See also Restatement (Second) of Torts § 402A (1965), comment *i*, which describes an unreasonably dangerous article as one which is "dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics."

2. the frequency of such injury;
3. the effect upon the performance or availability of a product when the degree of the anticipated injury or the frequency of such industry [*sic*] is reduced; and
4. an evaluation of the utility of the product, in absolute terms and in varying modes of risk.[14]

A balance of the likelihood and seriousness of injury against the burden on the manufacturer to take appropriate precautions has been the traditional test for reasonableness of a risk of injury.[15] The likelihood and seriousness of an injury can be reduced by safe design, careful construction, or adequate labeling and warnings to users.

The emphasis in earlier safety legislation was primarily upon reducing injuries by improving labeling to provide adequate warning to consumers. One of the precursors to the Act, the Federal Hazardous Substances Act (FHSA),[16] whose enforcement was transferred from the Food and Drug Administration (FDA) to the Consumer Product Safety Commission, sought to protect consumers against unreasonable risk of injury by providing for cautionary labeling on household substances including toys. Under the FHSA, the test for an unreasonable risk of injury involved consideration of evidence of injuries and their seriousness, as well as the likelihood of additional occurrences and the effectiveness of cautionary labeling in minimizing the hazard. Judge Friendly, in *R.B. Jarts v. Richardson,*[17] applied these tests in upholding an FDA finding that a game called "Jarts"[18] presented a "mechanical hazard"[19] and thereby posed an unreasonable risk of harm.

> While the point of the nose [of the Jart] is somewhat blunted, we do not understand petitioner seriously to question that the Commissioner could permissibly decide that the Jart presented a mechanical hazard . . . if it is

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[14]S. REP. No. 92-749, 92d Cong., 2d Sess. 6 (1972).

[15]W. PROSSER, LAW OF TORTS § 31, at 149 (4th ed. 1971) [hereinafter cited as PROSSER]. *See also* United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947).

[16]15 U.S.C. §§ 1261-74 (1970).

[17]438 F.2d 846 (2d Cir. 1971).

[18]"The Jart is a dart, about 13 [inches] long and weighing about half a pound, with three plastic fins, an aluminum shaft and a metal nose; as a result of its design and weight distribution, it will tend to land nose-first when thrown in the air. . . ." *Id.* at 850.

[19]A "mechanical hazard" is defined under the Federal Hazardous Substances Act as follows:

> An article may be determined to present a mechanical hazard if, in normal use or when subjected to reasonably foreseeable damage or abuse, its design or manufacture presents an unreasonable

> a "toy or other article intended for use by children." In any event the evidence of injuries . . . and simple common sense constitute sufficient basis for a determination that it presents a mechanical hazard, at least "when subjected to reasonable foreseeable . . . abuse."[20]

Since the hazard was necessarily present in the article, design modification consistent with its purpose was impracticable. However, the risk could be made reasonable with no cost or performance penalty by enabling the consumer to appraise the likelihood and severity of the risk through proper labeling giving adequate directions and warnings for safe use.[21]

The test for reasonableness of risk was aptly summarized by the National Commission on Product Safety in its final report to Congress recommending adoption of the Act. The Commission supplemented its own guidelines with the following statement:

> "Risks of bodily harm to users are not unreasonable when consumers understand that risks exist, can appraise their probability and severity, know how to cope with them, and voluntarily accept them to get benefits that could not be obtained in less risky ways. When there is a risk of this character, consumers have reasonable opportunity to protect themselves; and public authorities should hesitate to substitute their value judgments about the desirability of the risk for those of the consumers who choose to incur it.
>
> "But preventable risk is not reasonable (a) when consumers do not know that it exists; or (b) when, though aware of it, consumers are unable to estimate its frequency and severity; or (c) when consumers do not know how to cope with it, and hence are likely to incur harm unnecessarily; or (d) when risk is unnecessary in . . . that it could be reduced or eliminated at a cost in money or in the performance of the product that consumers would willingly incur if they knew the facts and were given the choice."[22]

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risk of personal injury or illness (1) from fracture, fragmentation, or disassembly of the article, (2) from propulsion of the article (or any part or accessory thereof), (3) from points or protrusions, surfaces, edges, openings, or closures . . . .

15 U.S.C. § 1261(s) (1970).

[20]438 F.2d at 850.

[21]Dreisonstok v. Volkswagenwerk, A.G., 489 F.2d 1066 (4th Cir. 1974); Dillard & Hart, *Product Liability: Directions for Use and the Duty to Warn*, 41 VA. L. REV. 145 (1955); Noel, *Manufacturer's Negligence of Design or Directions for Use of a Product*, 71 YALE L.J. 816 (1962).

[22]NCPS, *supra* note 5, at 11 (quoting testimony of Prof. Corwin D. Edwards before the NCPS on March 4, 1970).

By applying those indicia, the Commission has found unreasonable risks associated with several classes of consumer products for which it has initiated its standard-setting mandate. These products include power lawn mowers,[23] bicycles,[24] bookmatches,[25] architectural glass,[26] and swimming pool slides.[27] Each of these products ranks high on the Commission's "Frequency-Severity Index"[28] and can, to some extent, be made less hazardous with only minor cost and performance penalties.[29]

B. Imminent Hazard

When the Commission finds that a consumer product presents an "imminent and unreasonable risk of death, serious illness, or severe personal injury,"[30] it may immediately seek injunctive relief against the manufacturer, distributor, or retailer of the product. The injunctive relief may bar further distribution, require notification to consumers via national television or otherwise, and require recall, replacement, or refund.[31]

To sustain its action, the Commission must persuade the court that the product presents not only an unreasonable risk of harm, but that the potential harm is of such immediate and serious consequences that prompt injunctive relief is warranted. In its notice of a finding of an imminent hazard associated with the use of various spray adhesives,[32] the Commission determined that the use of certain adhesives could cause chromosome damage leading to genetic birth defects. In making this determination,

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[23]39 Fed. Reg. 26,662 (1974).

[24]*Id.* at 26,100. After receiving more than fifty written communications concerning these proposed regulations, the Commission suspended indefinitely their effective date. *Id.* at 43,536.

[25]*Id.* at 32,050.

[26]*Id.* at 18,502.

[27]*Id.* at 24,028.

[28]*See* note 59 *infra.*

[29]118 CONG. REC. 31,382 (1972). Representative Carney, expressing his support for the Act, observed that many products can be made safer at little expense. As examples, he cited refrigerators with a magnetic latch to prevent entrapment, electric drills with double insulation to prevent electrical shock, TV sets using less flammable materials, and wringer washers with an instinctive release. In each case, the safety feature imposed little or no cost penalty.

However, not all the Commission's safety standards are as compelling as Congressman Carney suggests. For example, there has been widespread criticism of the reasonableness of the Commission's proposed regulations for bicycles. *See* note 24 *supra.*

[30]15 U.S.C. § 2061(a) (Supp. III, 1973).

[31]*Id.* § 2061(b)(1).

[32]38 Fed. Reg. 22,569 (1973). The finding of imminent hazard was subsequently withdrawn because the data on which it was based was not reproducible. 39 Fed. Reg. 3582 (1973).

the Commission suggested that an imminent hazard will arise when the nature, severity, and duration of anticipated injury is significant.[33] Moreover, the generally accepted meaning of the term "imminent hazard" is that harm is reasonably certain to occur and can be averted only by swift action.[34] In the original Senate bill, a hazard was said to be "imminent" when action was required "prior to the completion of administrative proceedings held pursuant to this Act."[35]

In *United States Consumer Product Safety Commission v. A.K. Electric Corp.*,[36] the Commission sought to enjoin the sale and distribution of an automobile trouble light. The A.K. trouble light, one of several embraced by the Commission's complaint, was an extension-type light with a female electrical receptacle in its handle. Because of the flexible construction of the handle, the prongs of the receptacle could protrude and expose the user to a possibly fatal electrical shock.[37] The Commission had no

[33]38 Fed. Reg. 22,569 (1973).

[34]Employers' Liab. Assurance Corp. v. Columbus McKinnon Chain Co., 13 F.2d 128 (W.D.N.Y. 1926) (defective chain reasonably certain to place life or limb in peril is imminently dangerous); Jump v. Ensign-Bickford Co., 117 Conn. 110, 118, 167 A. 90, 92 (1933) (defective blasting fuse is imminently dangerous because it is fraught with immediate peril and carries a threat of serious impending danger); Coca-Cola Bottling Works v. Shelton, 214 Ky. 118, 282 S.W. 778 (1926) (improperly charged soft drink bottles present imminent danger).

[35]S. 3419, 92d Cong., 2d Sess. § 311 (1972). In its review of the bill, the Senate Commerce Committee expressed its understanding of the emergency provisions of the Act as follows:

> Section 311 allows the Administrator or the Attorney General to file an action seeking a Federal court to restrain any person in the distribution chain who is marketing a consumer product which is "imminently hazardous". An "imminently hazardous consumer product" is defined as a "consumer product presenting an unreasonable risk of injury or death which requires action to protect adequately the public health and safety prior to the completion of administrative proceedings held pursuant to this Act." For example, a toy may possess an electrical hazard which could cause injury to children during the period for promulgation [of] a product safety standard. In that situation, the Administrator could ask the court to take action to remove the dangerous toy from the marketplace pending completion of the standard-setting process. Or, a product that has been declared a banned hazardous substance may be so dangerous as to require its total recall instead of a recall limited to those products sold after the publication of the proposal to ban.

S. REP. No. 92-749, 92d Cong., 2d Sess. 35 (1972).

[36]Civil No. 74-1206 (D.D.C., Sept. 9, 1974).

[37]Transcript, Vol. I, at 5, Public Hearing Before the Consumer Product Safety Comm'n, *In re* A.K. Electric "Trouble Light" (July 31, 1974). The Commission alleged that one death had already been caused by the trouble light. Transcript at 14, United States Consumer Prod. Safety Comm'n v. A.K. Electric Corp., Civil No. 74-1206 (D.D.C., Sept. 9, 1974).

trouble persuading Judge Hart that the A.K. trouble light presented an imminent hazard. In a lively dialogue with defendant's counsel during the hearing, Judge Hart asserted that the product was a deathtrap.[38] In its order enjoining further manufacture or distribution and ordering that the product be recalled, the court found that a large number of trouble lights with flagrant design and construction defects had been sold, and that users of these lights were subject to risks of severe injury or death.[39]

When the Commission has evidence of serious injury or death and reason to believe that additional injuries are likely to occur before the standard-setting procedure can operate, a finding of imminent hazard is appropriate. As the results in *A.K. Electric* indicate, this procedure provides the Commission with a swift and effective mechanism to protect consumers.

C. Substantial Product Hazard

Section 15(b) of the Act and subsequent Commission rulemaking require manufacturers, distributors, and retailers to notify the Commission within twenty-four hours after obtaining information "which reasonably supports the conclusion that such product . . . contains a defect which could create a substantial product hazard . . . ."[40] A "substantial product hazard" is defined in the Act as

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[38]Transcript at 7, United States Consumer Prod. Safety Comm'n v. A.K. Electric Corp., Civil No. 74-1206 (D.D.C., Sept. 9, 1974).

> THE COURT: . . . [Y]ou have here a product that is so obvious to this Court, the hazard to anyone using it, it is a simple deathtrap, that the Court feels that it must take action to see that the public is protected. . . .
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> MR. JOSEPH: . . . But, Your Honor, as to Your Honor's statement that the product itself is at least, the Court has indicated that it is an inherently dangerous product. I would have to take issue, most respectfully, with the Court, on that.
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> THE COURT: You may take issue, but if we are talking about the exhibit that was put in evidence on the temporary restraining order, I think it is so patently a danger and a deathtrap that this Court is not likely to change its mind on the matter.
>
> MR. JOSEPH: But, you would, Your Honor, of course, preserve to the defendants the right to present some evidence on that issue. We have had no opportunity whatsoever to cross-examine or to inquire into the determinations made by the Commission. We may have some expert testimony of our own to present to the Court.
>
> THE COURT: You may, and you might have expert testimony that you could set off a stick of dynamite on that table and not endanger anyone, but it wouldn't be very effective.

[39]Declaratory Judgment and Permanent Injunction at 1, United States Consumer Prod. Safety Comm'n v. A.K. Electric Corp., Civil No. 74-1206 D.D.C., Sept. 9, 1974).

[40]15 U.S.C. § 2064(b) (Supp. III, 1973) [hereinafter referred to as

(1) a failure to comply with an applicable consumer product safety rule which creates a substantial risk of injury to the public, or

(2) a product defect which (because of the pattern of defect, the number of defective products distributed in commerce, the severity of the risk, or otherwise) creates a substantial risk of injury to the public.[41]

To fall within section 15(a) the product must first be defective. For the purpose of the Act, a product may be defective when it fails to comply with an applicable consumer product safety rule. However, since it is likely that for the vast majority of consumer products there will be no applicable product safety rules, it is important to consider the kinds of defects which will bring a product within the second category of substantially hazardous products. It is clear from a reading of the Act that Congress intended to reach all types of defects which could cause a substantial risk of injury. Generally, a product is defective whenever it fails to perform in the manner reasonably expected.[42] Historically, in actions founded on negligence and strict liability, courts have included in the concept of a defective product those products having manufacturing defects,[43] products not accompanied by adequate instructions and warnings of the dangers attending use,[44] and products properly made according to an unreasonably dangerous design.[45]

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section 15(b)]. The twenty-four hour deadline was later added by the Commission. 39 Fed. Reg. 6068 (1974).

[41]15 U.S.C. § 2064(a) (Supp. III, 1973) [hereinafter referred to as section 15(a)].

[42]Dunham v. Vaughan & Bushnell Mfg. Co., 42 Ill. 2d 339, 247 N.E.2d 401 (1969) (metal chip broke off hammer while striking metal pin); Santor v. A & M Karagheusian, Inc., 44 N.J. 52, 207 A.2d 305 (1965) (carpet which was unfit for normal wear was defective); Markle v. Mulholland's, Inc., 265 Ore. 259, 509 P.2d 529 (1973) (recapped tire blew out within period of anticipated use); Engberg v. Ford Motor Co., 205 N.W.2d 104 (S.D. 1973) (seat belts must restrain driver during collision). *See also* PROSSER § 99, at 659; Dickerson, *Products Liability: How Good Does a Product Have To Be?*, 42 IND. L. J. 301 (1967); Keeton, *Products Liability—Liability Without Fault and the Requirement of a Defect*, 41 TEXAS L. REV. 855 (1963); Rheingold, *Proof of Defect in Product Liability Cases*, 38 TENN. L. REV. 325 (1971).

[43]Bradford v. Bendix-Westinghouse Automotive Air Brake Co., 517 P.2d 406 (Colo. Ct. App. 1973) (manufacturing defect in brake pedal).

[44]R.B. Jarts v. Richardson, 438 F.2d 846 (2d Cir. 1971); Wright v. Carter Prod., 244 F.2d 53 (2d Cir. 1957).

[45]Pike v. Frank G. Hough Co., 2 Cal. 3d 465, 467 P.2d 229, 85 Cal. Rptr. 629 (1970) (defective design of pay dozer which restricted operator's vision was unreasonable); Berkebile v. Brantly Helicopter Corp., 219 Pa. Super. 479, 281 A.2d 707 (1971) (defective design of helicopter rotor blade unreasonably dangerous).

When a product is defective because it is made according to an unreasonably dangerous design, the Senate Commerce Committee[46] has suggested that the Commission can eliminate the hazard either by setting appropriate standards or by seeking an injunction under its imminent hazard procedure. It can be argued that omission of any reference to design defects in the Senate's report should be construed to remove such defects from the operation of section 15. Such a reading, however, would remove from the Commission the power to take prompt administrative action to cause the repair or recall of a product which presents a substantial risk of injury to the public. Moreover, to predicate recall of a dangerous product on the origin of the defect causing the hazard, rather than on the existence of the hazard, would be inconsistent with the Act's purpose of protecting consumers.

The limited use of the phrase "substantial risk of injury" within section 15 in the context of defect notification and recall, instead of the more conventional "unreasonable risk of injury" as used generally throughout the Act, suggests that Congress intended a different standard to apply to the former risk classfication. When read in context with the power of the Commission to require notice, recall, or refund upon a finding of a substantial risk of injury, where no such action could be ordered following a finding of a merely unreasonable risk, the phrase "substantial risk of injury" suggests the existence of a more serious level of risk in terms of the frequency or severity of the anticipated injury. Moreover, the first part of the definition of a substantial product hazard implies that not all violations of product safety rules, which are instituted to eliminate unreasonable hazards, create substantial product hazards; rather, only those violations which create a substantial risk of injury rise to the level of substantial product hazard.

What, then, is a substantial risk of injury? In the original Senate version of the bill, the comparable section required notice to consumers of defects related to the safety or use of the product which present an unreasonable risk of injury or death.[47] The House version, on the other hand, spoke only of a product defect which creates a substantial hazard to the public.[48] By analogy to earlier safety legislation, the term "substantial" in the House version and in the Act would appear to exclude only those hazards which are wholly insignificant, negligible, or trivial.[49]

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[46]S. REP. No. 92-749, 92d Cong., 2d Sess. 36 (1972).

[47]S. 3419, 92d Cong., 2d Sess. § 313 (1972).

[48]H.R. 15,003, 92d Cong., 2d Sess. § 15(a)(2) (1972)

[49]The Federal Hazardous Substances Act defines a hazardous substance as, *inter alia*, a product that "may cause substantial personal injury or substantial illness." 15 U.S.C. § 1261(f) (1970). "Substantial personal injury or illness"

Congressional intent that "substantial" hazard was to be broadly construed to include any defect affecting the safety of the product was expressed during the House debate on the Act wherein both Congressmen Halpern and Donohue referred to section 15 as allowing the Commission to "administratively order the notification and remedy of products which fail to comply with Commission safety rules or *which contain safety defects.*"[50] The only qualification to this otherwise sweeping statement appears in the accompanying House Commerce Committee report, which adds: "This definition looks to the extent of public exposure to the hazard. A few defective products will not normally provide a proper basis for compelling notification under this section."[51] This last qualification would presumably allow a few defective products, as could be expected due to the finite imprecision of any practicable quality control program.

The legislative history of section 15, coupled with well-established principles of products liability, thus suggest that a substantial product hazard is one in which (1) a nontrivial or moderately serious injury to a consumer is reasonably foreseeable due to any defect in the product, and (2) more than only a small quantity of the consumer product is defective. Each of the three "substantial hazard" proceedings initiated to date by the Commission easily meets this two-pronged test for a substantial product hazard. The three fact situations encompass design and manufacturing defects found in large numbers of each product. In each case the defect was capable of causing serious personal injury. In *In re McCulloch Corp.*,[52] the Commission staff concluded that over 300,000 gasoline-powered chain saws had potentially leaking fuel hoses and thereby presented a risk of fire or explosion. In *In re National Presto Industries, Inc.*,[53] 4,000,000 electric frying pans were suspected of high electrical current leakage with the possibility of causing serious electrical shock. In *In re Relco, Inc.*,[54] over 200,000 arc welders had high voltage terminals which were exposed and presented a potentially lethal shock hazard.

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is defined in the regulations as any injury or illness of a significant nature. It need not be severe or serious. What is excluded by the word "substantial" is a wholly insignificant or negligible injury or illness. 16 C.F.R. § 1500.3(c)(7)(ii) (1974), *noted in* Levine, *Statutory Liability: The Federal Hazardous Substances Labeling Act—Sword or Shield?*, 19 FOOD DRUG COSM. L.J. 412, 420 n.42 (1964).

[50] 118 CONG. REC. 31,391 (1972) (emphasis added).

[51] H.R. REP. No. 92-1153, 92d Cong., 2d Sess. 42 (1972).

[52] No. 74-1 (Consumer Product Safety Comm'n, Mar. 4, 1974).

[53] No. 74-2 (Consumer Product Safety Comm'n, Apr. 12, 1974).

[54] No. 74-4 (Consumer Product Safety Comm'n, filed Aug. 7, 1974).

Except for *Relco*, which is as yet undecided, each of the foregoing section 15 actions ended in stipulated settlements providing for the issuance of defect notices to consumers. Consequently, there has yet to be either an administrative or judicial determination of what constitutes a substantial product hazard. Relco has brought a collateral action in federal district court challenging the substantial product hazard classification, urging that the lack of sufficient standards to which a product must conform makes the section void for vagueness.[55] Since Relco cannot be required to notify its customers of the alleged hazard or initiate a recall program until after a judicially reviewable administrative hearing, its due process rights are protected.[56] Nevertheless, Relco could be subject to a fine under section 19 for "knowingly" failing to notify the Commission of a suspected substantial product hazard in the first instance.[57] However, in the absence of a final order declaring that a specific product presents a substantial product hazard, the unspecific language of section 15 makes it unlikely that a section 19 sanction will be enforceable against a manufacturer, distributor, or retailer who in good faith decides that his product does not present a substantial product hazard.

This brief analysis of the three risk classifications leads to the conclusion that a substantial product hazard requires something more than a showing of mere unreasonableness. Not all unreasonably dangerous products pose a substantial risk of injury, but all substantial product hazards are unreasonable. On the other hand, the magnitude of the risk created by a substantially hazardous product need not reach the level of severe personal injury or death as is characteristic of an imminently hazardous product, although the cases cited do not exclude this possibility. Finally, all imminent hazards are both substantial and unreasonable.

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[55]Plaintiff's Response in Opposition to Defendant's Motion to Dismiss at 16, Relco, Inc. v. Consumer Prod. Safety Comm'n, Civil No. 74-H-362 (S.D. Tex., filed Mar. 12, 1974), *citing* Connally v. General Constr. Co., 269 U.S. 385 (1926). The *Connally* Court stated that "a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law." *Id.* at 391.

[56]Defendant's Motion to Dismiss at 12, Relco, Inc., v. Consumer Prod. Safety Comm'n, Civil No. 74-H-362 (S.D. Tex., filed Mar. 12, 1974), *citing* Ewing v. Mytinger & Castleberry, Inc., 339 U.S. 594 (1950).

[57]15 U.S.C. § 2069(c) (Supp. III, 1973) [hereinafter referred to as section 19]:

> [T]he term "knowingly" means (1) the having of actual knowledge, or (2) the presumed having of knowledge deemed to be possessed by a reasonable man who acts in the circumstances, including knowledge obtainable upon the exercise of due care to ascertain the truth of representations.

IV. Injury Information

A. Information Sources

In addition to effecting the removal of dangerous products from the hands of consumers, a major thrust of the Act is to generate data on injuries caused by consumer products. Information gathering is stimulated by several provisions of the Act which taken together will result in a reservoir of detail on actual and potential product defects. In the hands of the Commission, the information is valuable in setting priorities and in identifying product categories requiring closer scrutiny before the selection of a specific mode of relief. In the hands of an injured plaintiff, this information is potentially of significant value in stimulating discovery and as evidentiary material.

There are three sources of information available under the Act. The first and most automated is the National Electronic Injury Surveillance System (NEISS) maintained as part of the Injury Information Clearinghouse.[58] NEISS is a computerized data collection system connected to 119 hospital emergency rooms throughout the United States.[59] When an injury attributable to a consumer product is treated at one of these emergency rooms, this information is entered into a computer memory bank along with details of the type of product involved and the severity of the injury. The system thus contains a continuously updated profile of injury-causing products. The output of the computer is published annually, listing by product classification the number and severity of each reported injury.

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[58] *Id.* § 2054(a):

> The Commission shall—
> (1) maintain an Injury Information Clearinghouse to collect, investigate, analyze, and disseminate injury data, and information, relating to the causes and prevention of death, injury, and illness associated with consumer products; and (2) conduct such continuing studies and investigations of deaths, injuries, diseases, other health impairments, and economic losses resulting from accidents involving consumer products as it deems necessary.

[59] Consumer Product Safety Index Background Paper, September 28, 1973 (available from Consumer Product Safety Commission, Bureau of Epidemiology):

> Hospitals participating in NEISS represent about a 2 percent sample of all hospital emergency rooms in the Continental United States. Multiplying the number of injuries reported by 50 will give a very general estimate of how many injuries were treated in all emergency rooms nationwide. An independent study conducted by Market Facts, Inc., found that only 38 percent of all injuries result in emergency room treatment, the balance being treated in physicians' offices or at home.

The Commission selects from the NEISS results those product categories which, because of the frequency and severity of injuries received, deserve an in-depth hazard analysis. These analyses by Commission personnel are conducted by detailed investigation and are available publicly.[60] The hazard analysis lists the products involved and identifies the manufacturer, the nature of the defect, and the apparent cause of the injury.

Supplementing NEISS and the in-depth hazard analyses are the notices received by the Commission under section 15(b). These notices are supplied by manufacturers, distributors, and retailers who obtain information which reasonably supports the conclusion that a product fails to comply with an applicable consumer product safety rule or contains a defect which could create a substantial product hazard. Subsequent to the initial notification given to the Commission within twenty-four hours of reaching the above conclusion, a manufacturer, distributor, or retailer must identify the product, describe the potential hazard, and give the date when the information supporting the existence of the hazard was obtained, the manner in which the information was obtained, the nature of the potential injury, the number and severity of such injuries, the number of products which present the hazard, the number of units in the hands of consumers, shipping dates and destinations, identifying marks or numbers, corrective action being taken, engineering and quality control changes to be made, whether refund or repair actions have been taken, whether notice has been or will be given, and plans for disposition of finished goods.[61] Copies of section 15 notices are publicly disclosed except as limited by the Act to exclude trade secret information.[62]

Finally the Commission has taken a significant step, as authorized by the Act, by proposing extensive recordkeeping requirements.[63] The proposed rule would require that records of all consumer product safety complaints received after the effective date of the rule, regardless of the truth of the allegation, be

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[60]In-depth analyses are available from the Consumer Product Safety Commission, Bureau of Epidemiology, on Bicycles (1973), Fireworks (1973), Infant Seats (1974), Fire Extinguishers (1974), High Chairs (1974), Baby Walkers (1974), Aerosol Cans (1974), Liquefied Petroleum Gas (1974), and Power Jointers (1974).

[61]39 Fed. Reg. 6061 (1974).

[62]There have been approximately 180 section 15 notices to the Commission since June 1973, affecting in excess of 12 million consumer product units. More than half the defects are capable of causing either fire or electrical shock. Another one-fourth of the defects are related to gas leakage, leading to the possibility of explosion, or loss of control of bicycles and rider mowers. The mean number of units affected by a defect notice is 60,000 units, but three notices affect in excess of one million units each.

[63]39 Fed. Reg. 31,916 (1974).

maintained for a period of at least five years from date of receipt. The rule would require further that the record of safety complaints contain a copy or memorandum of the complaint, a record of any lawsuits filed related to the safety complaint, an analysis of the allegations of the complaint including such records as technical studies, tests, or other records of investigation, and any written response to the complainant.

B. Effect on Private Product Liability Action

The several informational activities discussed above provide to a potential plaintiff a wealth of data which could show a pattern of defect-related injuries identical to his own. This data gives the plaintiff a unique view of the defendant's prior and subsequent accident history, including the number and type of injuries, names of injured claimants, results of any defect analyses made by the manufacturer, as well as any subsequent design changes or repairs. That such information could have a marked effect on private products liability litigation was acknowledged by the Commission in the preamble to the proposed recordkeeping requirements.[64]

Detailed product injury data is valuable in actions brought under theories of either negligence or strict liability.[65] In a negligence action, plaintiff must show that defendant failed in his duty to exercise reasonable care under the circumstances.[66] In particular, a manufacturer may be negligent for failing to discover and correct defects in his products. When a defendant manufacturer has notice of such defects but has failed to take corrective action, he has breached his duty of care. Evidence of prior accidents involving the same product under similar circumstances is discoverable[67] and may be admissible to show notice to the defendant of the hazardous nature of the product.[68]

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[64]*Id.*

[65]*See* Rheingold, *supra* note 42.

[66]PROSSER § 96, at 644.

[67]Tytel v. Richardson-Merrell, Inc., 37 F.R.D. 351 (S.D.N.Y. 1965) (names and addresses of injured claimants discoverable); Cohen v. Proctor & Gamble, Inc., 18 F.R.D. 301 (D. Del. 1955) (names and addresses of claimants compensated for injuries discoverable); Bleacher v. Bristol-Myers Co., 53 Del. 1, 163 A.2d 526 (1960) (records of prior claims and lawsuits of a similar nature discoverable). *But see* Johnson v. Stemco, 11 F.R.D. 603 (N.D. Ohio 1951) (names of injured persons held irrelevant and of doubtful admissibility); Proctor & Gamble Distrib. Co. v. Vasseur, 275 S.W.2d 941 (Ky. Ct. App. 1955) (discovery of names and addresses of complaining users and list of lawsuits brought by other users refused as irrelevant). *See generally* Annot., 20 A.L.R.3d 1430 (1968).

[68]Prashker v. Beech Aircraft Corp., 258 F.2d 602 (3d Cir.), *cert. denied*, 358 U.S. 910 (1958) (trial court properly allowed introduction of seven accident reports, limited solely to issue of notice of alleged defects in airplane);

In an action founded on a theory of strict liability, the proof of a defect and its unreasonableness can be aided by a showing of a pattern of injuries due to the same defect. The existence of such a pattern would be aided by NEISS data compilations, the results of in-depth hazard analyses, and other Commission investigative reports which are admissible as exceptions to the hearsay rule.[69] Moreover, section 15(b) notices should be admissible as an admission by a party-opponent that he had obtained information which reasonably supported the conclusion that his product either failed to comply with an applicable consumer product safety rule or contained a defect which could create a substantial product hazard.[70]

Records kept pursuant to section 15(b) and the above-mentioned proposed rules disclose prior and subsequent accidents, claims, and corrective actions taken. Evidence of subsequent accidents is generally not admissible to prove that a supplier was negligent in manufacturing a particular product, but such evidence might not be excluded when it is probative of other relevant issues. For example, evidence of subsequent accidents may be admissible to prove that the product was in fact dangerous.[71] Similarly, evidence of subsequent corrective measures or design changes is irrelevant to the issue of defendant's negligent conduct at the time of the accident and probably therefore is not admissible.[72] However, when used to demonstrate the defective

Wright v. Carter Prod., 244 F.2d 53 (2d Cir. 1957) (trial court erred in refusing Federal Trade Commission findings of harmful propensities of deodorant); Becker v. American Airlines, Inc., 200 F. Supp. 243 (S.D.N.Y. 1961) (evidence of prior malfunctions of identical altimeters admitted); Berry v. Fruehauf Trailer Co., 371 Mich. 428, 124 N.W.2d 290 (1963) (evidence of prior accident involving ramp of trailor on other equipment where both ramps of similar design admitted); Miller v. A.B. Kirschbaum, 298 Pa. 560, 148 A. 851 (1930) (evidence admissible that, on three occasions within preceding five years, like accidents had occurred from the same cause, of which defendant had knowledge). *See* 1 L. FRUMER & M. FRIEDMAN, PRODUCTS LIABILITY § 12.01, at 232 (1974); MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 200, at 473 (2d ed. E. Cleary 1972) [hereinafter cited as MCCORMICK]; D. NOEL & J. PHILLIPS, PRODUCTS LIABILITY IN A NUTSHELL 249 (1974); 2 J. WIGMORE, EVIDENCE § 252, at 458 (3d ed. 1940). *See generally* Annot., 42 A.L.R.3d 780 (1972).

[69]FED. R. EVID. 803(8).

[70]MCCORMICK § 262, at 628.

[71]Ginnis v. Mapes Hotel Corp., 86 Nev. 408, 470 P.2d 135 (1970) (evidence of subsequent accidents involving same door admitted to prove faulty design or manufacture); DiPangrazio v. Salemonsen, 64 Wash. 2d 720, 393 P.2d 936 (1964) (evidence of subsequent accident is relevant in determining hazardous nature of product).

[72]FED. R. EVID. 407; Price v. Buckingham Mfg. Co., 110 N. J. Super. 462, 266 A.2d 140 (1970) (evidence of modification of seat belt snap after accident not admissible in relation to issue of negilgence).

condition of the product at the time of the injury, such evidence may be admissible.[73]

From a defense standpoint, the absence of any injuries associated with a product is generally admissible for the purpose of proving the absence of a defective condition.[74] But such evidence is not conclusive since the defect may be present in only certain lots or under certain conditions of use.[75] However, when the extensive data-gathering activity carried on pursuant to the Act fails to disclose a single injury associated with a widely used consumer product, the inference that a product is safe and not defective may be stronger.[76]

V. Conclusion

It is reasonable to expect that the data compiled by the Consumer Product Safety Commission under its several grants of authority will be used by injured plaintiffs in seeking to prove negligence or defectiveness. More importantly, the mere availability of this data should provide ample motivation to a manufacturer to improve the safety of his product. Indeed, the impact of this data in stimulating product safety improvements may

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[73]Kate Mahoney v. Roper Wright Mfg. Co., Civil No. CV-70-156-D (7th Cir., Dec. 19, 1974); Bailey v. Kawasaki-Kisen, K.K., 455 F.2d 392 (5th Cir. 1972); Eastern Airlines, Inc. v. American Cyanamid, 321 F.2d 683 (5th Cir. 1963); Steele v. Wiedemann Mach. Co., 280 F.2d 380 (3d Cir. 1960); Ault v. International Harvester Co., 528 P.2d 1148, 117 Cal. Rptr. 812 (1974) (evidence of post-accident design change held properly admitted in action founded on theory of strict liability); *accord,* Sutkowski v. Universal Marion Corp., 5 Ill. App. 3d 313, 281 N.E.2d 749 (1972).

[74]Hardman v. Helene Curtis Indus., Inc., 48 Ill. App. 2d 42, 198 N.E.2d 681 (1964); William Laurie Co. v. McCullough, 174 Ind. 477, 90 N.E. 1014 (1910); Savage v. Peterson Distrib. Co., 379 Mich. 197, 150 N.W.2d 804 (1967). *But see* Hodges v. Bearse, 129 Ill. 87, 21 N.E. 613 (1889); Nave v. Flack, 90 Ind. 205 (1883). *See generally* Morris, *Proof of Safety History in Negligence Cases,* 61 Harv. L. Rev. 205 (1948); Rheingold, *supra* note 42.

[75]Walker v. Trico Mfg. Co., 487 F.2d 595 (7th Cir. 1973), *cert. denied,* 415 U.S. 978 (1974).

[76]Clever Idea Co. v. Consumer Prod. Safety Comm'n, Civil No. 74-C-1638 (E.D.N.Y., Dec. 4, 1974). In granting plaintiff's application for a preliminary injunction which sought to restrain the Commission from enforcing its banning order following a finding of a mechanical hazard within the Federal Hazardous Substances Act, 15 U.S.C. § 1261(s) (1970), the court stated:

> [T]he Court finds it difficult to believe that the plaintiff's products [paper and blow-out horns with plastic mouthpieces manufactured for thirty years at a rate of two million per year] withstood so many years of normal child use, damage and abuse without *one single complaint or alleged defect* if they really do constitute a hazardous item or present an unreasonable risk of personal injury as the government contends.

(emphasis added). *See also* McCormick § 200, at 476.

far exceed the statutory remedies or the standard-setting activities of the Commission which are both slow and costly. The data collection process itself is relatively inexpensive and relying as it does on "self-policing" has the ability to reach each manufacturer of every product long before the Commission can reach him through its other powers.

JOHN T. LAMACCHIA

The Impeachment Exception: Decline of the Exclusionary Rule?

I. Introduction

Since its inception in 1914 in *Weeks v. United States*,[1] the exclusionary rule has become one of the chief remedies for the protection of constitutional guarantees in the criminal process. The rule, which precludes admission of evidence procured in violation of a defendant's rights in certain circumstances, has been applied in a number of situations to protect rights guaranteed by the fourth, fifth, sixth, and fourteenth amendments.[2]

The doctrinal basis of the rule varies with its applications. The self-incrimination clause of the fifth amendment mandates the exclusion of involuntary, self-incriminatory statements.[3] The basis for the rule in other cases seems to be two-fold. First, it is believed that the constitutional guarantee would be worthless without exclusion as a remedy to deter violations.[4] Secondly, it is

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[1]232 U.S. 383 (1914).

[2]Many applications of the rule involve more than one guarantee, and grouping of the applications under headings of single constitutional provisions is for illustrative purposes only. Exclusion has also been used to remedy violations of rights not of constitutional stature. In McNabb v. United States, 318 U.S. 332 (1943), and Mallory v. United States, 354 U.S. 449 (1957), the Court held that a voluntary statement given by a defendant in the custody of federal officers was inadmissible if given during an unnecessary delay in bringing defendant before a federal magistrate. In Nardone v. United States, 302 U.S. 379 (1937), and Nardone v. United States, 308 U.S. 338 (1939), statements intercepted by wiretapping in violation of the Federal Communications Act of 1934, 47 U.S.C. § 605 (1970) (as amended), were declared inadmissible.

The *McNabb-Mallory* rule was abrogated by the Omnibus Crime Control and Safe Streets Act of 1968, 18 U.S.C. § 3501(c) (1970). The *Nardone* rule was modified by 18 U.S.C. §§ 2510-20 (1970) and 47 U.S.C. § 605 (1970), which provide for exclusion in some cases of illegal wiretapping. *See also* United States v. Thomas, 474 F.2d 110 (10th Cir.), *cert. denied*, 412 U.S. 932 (1973) (rule of exclusion established for evidence obtained in violation of the canons of ethics).

[3]"The Fifth Amendment in and of itself directly and explicitly commands its own exclusionary rule—a defendant cannot be compelled to give evidence against himself." Coolidge v. New Hampshire, 403 U.S. 443, 498 (1971) (Black, J., dissenting).

[4]This was first expressed in Weeks v. United States, 232 U.S. 383 (1914):

> If letters and private documents can thus be seized and held and used in evidence against a citizen accused of an offense, the protection of the Fourth Amendment declaring his right to be secure against such searches and seizures is of no value, and so far as those thus placed

felt that "judicial integrity" requires that courts not become parties to violations of the Constitution by admitting evidence obtained through such violations.[5]

Although the exclusionary rule has been applied in many diverse situations, its use is limited by several factors, including the burden on defendant to make a timely motion for suppression,[6] and the requirement of standing to challenge the introduction of the evidence, as well as various exceptions to the rule. The most important of these exceptions, and the only one as yet recognized by the United States Supreme Court, is the impeachment exception, which allows admission of otherwise excludable evidence for

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are concerned, might as well be stricken from the Constitution.

Id. at 393.

While exclusion is usually perceived as a deterrent to police violations, the Ninth Circuit has recently held that the rule should be applied to deter legislators from passing unconstitutional laws. Powell v. Stone, 507 F.2d 93 (9th Cir. 1974). In *Powell* the court held that evidence seized incident to an arrest under an unconstitutionally vague vagrancy ordinance should have been excluded, despite the arresting officers' good faith in relying on the ordinance. The denial of a "good faith" defense is not a novel holding, as the *Powell* court recognized. *See* Almeida-Sanchez v. United States, 413 U.S. 266 (1973); Coolidge v. New Hampshire, 403 U.S. 443 (1971) (evidence seized under invalid statutes was excluded). But the *Powell* court's rationale seems novel: "the public interest is served by deterring legislators from enacting such statutes." 507 F.2d at 98.

[5]And if this Court should permit the Government, by means of its officers' crimes, to effect its purpose of punishing the defendants, there would seem to be present all the elements of a ratification. If so, the Government itself would become a lawbreaker.

Will this Court by sustaining the judgment below sanction such conduct on the part of the Executive? The governing principle has long been settled. It is that a court will not redress a wrong when he who invokes its aid has unclean hands.

Olmstead v. United States, 277 U.S. 438, 483 (1927) (Brandeis, J., dissenting) (footnote omitted).

This argument was "accepted" by the Court in McNabb v. United States, 318 U.S. 332, 338 (1943), and declared an "imperative of judicial integrity" in Elkins v. United States, 364 U.S. 206, 222 (1960). See Comment, *Judicial Integrity and Review: An Argument for Expanding the Scope of the Exclusionary Rule*, 20 U.C.L.A.L. REV. 1129 (1973).

[6]Gouled v. United States, 255 U.S. 298 (1921). Similar requirements are imposed in every state jurisdiction. In federal courts, however, failure to move for suppression at or before trial does not necessarily waive defendant's right to suppression. FED. R. CRIM. P. 52(b) provides that appellate courts shall have discretion to notice on their initiative "[p]lain errors or defects affecting substantial rights." Failure to exclude suppressable evidence may be such an error. Solomon v. United States, 408 F.2d 1306 (D.C. Cir. 1969).

Even when a state court has ruled that a defendant has waived his right to suppression, a federal court may review the question of waiver of the federal constitutional right. Henry v. Mississippi, 379 U.S. 443 (1965).

the purpose of impeaching a defendant who takes the stand on his own behalf. The exception originated in 1954 in *Walder v. United States*[7] and was given new vitality and impetus in 1971 in *Harris v. New York.*[8] The purpose of this Note is to examine the exclusionary rule and its probable future in terms of the effect of the impeachment exception on the continued usefulness of the rule as a constitutional remedy.

II. Origins and Development of the Rule

The exclusionary rule first developed in the area of unreasonable searches and seizures, and even today the rule is often narrowly applied to fourth amendment cases only. Exclusion of evidence because of the illegality of its procurement was unknown at common law,[9] although exclusion pursuant to a judicial determination of the lack of probative value of evidence offered was a basic feature of the law of evidence.

In 1886, the United States Supreme Court held, in *Boyd v. United States,*[10] that a defendant in a forfeiture proceeding could not be compelled by subpoena duces tecum to produce his business records, because such compulsory production was equivalent to an unreasonable seizure and because the fourth and fifth amendments prohibited the use of documents so obtained against their owner.[11] However, in 1904, *Boyd* was implicitly overruled in *Adams v. New York.*[12] Then, in 1914, the Court delivered the famous *Weeks v. United States*[13] opinion, holding that evidence obtained by federal officers through an unlawful search is not admissible in federal prosecutions.

The *Weeks* rule was soon expanded to exclude evidence derived from illegal searches and seizures.[14] The "derived" evidence,

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[7]347 U.S. 62 (1954).

[8]401 U.S. 222 (1971).

[9]McCormick's Handbook of the Law of Evidence § 165, at 365 (2d ed. E. Cleary 1972); 8 J. Wigmore, Evidence § 2183, at 6 (McNaughton rev. ed. 1961).

[10]116 U.S. 616 (1886).

[11]"[W]e have been unable to perceive that the seizure of a man's private books and papers to be used in evidence against him is substantially different from compelling him to be a witness against himself." *Id.* at 633.

[12]192 U.S. 585 (1904).

[13]232 U.S. 383 (1914).

[14]Silverthorne Lumber Co. v. United States, 251 U.S. 385 (1920). Justice Holmes, writing for the majority, said:

> The essence of a provision forbidding the acquisition of evidence in a certain way is not merely that evidence so acquired shall not be used before the court but that it shall not be used at all.

Id. at 392. In view of the exceptions to the rule, Justice Holmes' statement does not reflect the rule as it actually developed. See text accompanying notes 83-123 *infra.*

known as "fruit of the poisonous tree,"[15] is excluded if "tainted" by the unlawful act, unless the trial court finds that the connection between the act and the derived evidence has "become so attenuated as to dissipate the taint."[16] Verbal statements as well as tangible evidence may constitute "fruit."[17]

In 1949 in *Wolf v. Colorado*,[18] the Court refused to require exclusion of illegally seized evidence in state courts under the due process clause of the fourteenth amendment. The Court expressed the desire to allow the states to seek "other means of protection" for the guarantees of the fourth amendment.[19]

Exclusion from federal courts of evidence unlawfully seized by state officers was mandated in 1960.[20] This decision abrogated the "silver platter" doctrine,[21] which had existed since *Weeks*,[22] and rendered the legality of the seizure, rather than the character of the seizing authorities, the criterion of admissibility in federal court.[23] Then, in 1961 the Court decided *Mapp v. Ohio*,[24] hold-

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[15]The phrase was coined by Justice Frankfurter in Nardone v. United States, 308 U.S. 338, 341 (1939).

[16]*Id.* at 341.

[17]Wong Sun v. United States, 371 U.S. 471 (1963).

[18]338 U.S. 25 (1949).

[19]

> Accordingly, we have no hesitation in saying that were a state affirmatively to sanction such police incursion into privacy it would run counter to the guaranty of the Fourteenth Amendment. But the ways of enforcing such a basic right raise questions of a different order. How such arbitrary conduct should be checked, what remedies should be afforded, the means by which the right should be made effective, are all questions that are not to be so dogmatically answered as to preclude the varying solutions which spring from an allowable range of judgment on issues not susceptible of quantitative solution.

Id at 28.

[20]Elkins v. United States, 364 U.S. 206 (1960).

[21]This is another of Justice Frankfurter's phrases. Lustig v. United States, 338 U.S. 74, 79 (1949).

[22]*See* Lustig v. United States, 338 U.S. 74 (1949); Byars v. United States, 273 U.S. 28, 33 (1927); Center v. United States, 267 U.S. 575 (1925); Weeks v. United States, 232 U.S. 383, 398 (1914).

In 1957 the Court held that federal courts could enjoin the use in state courts of evidence unlawfully seized by federal officers. Rea v. United States, 350 U.S. 214 (1957). However, in Wilson v. Schnettler, 365 U.S. 381 (1961), a similar injunction was refused. In Cleary v. Bolger, 371 U.S. 392 (1963), the Court refused to enjoin the use in state court of evidence seized by federal officers in violation of the Federal Rules of Criminal Procedure.

[23]Evidence illegally seized by a private individual remains admissible, unless the individual acts for the police. See McCormick's Handbook of the Law of Evidence § 168 (2d ed. E. Cleary 1972).

[24]367 U.S. 643 (1961).

ing that the fourteenth amendment requires exclusion from state prosecutions of evidence seized in violation of the fourth amendment.[25] Justice Clark, writing for the majority, emphasized that the exclusionary rule was not merely an exercise of the Court's supervisory power over admission of evidence in the federal courts, but was constitutionally mandated.[26] Subsequently, the Court said that *Mapp* did not require state courts to adhere to federal formulations of search and seizure reasonableness, so long as their own standards did not infringe constitutional guarantees.[27]

In recent years, wiretapping[28] and electronic eavesdropping[29] have been held to be "searches" within the meaning of the fourth amendment, and accordingly, their products are subject to suppression when obtained by an unreasonable invasion of an area of constitutionally protected privacy.

A defendant's involuntary, self-incriminatory statements have long been recognized as inadmissible.[30] In *Miranda v. Arizona*[31] the Court announced the controversial rule that no statement given by a suspect during "custodial interrogation" was admissible unless he was first warned of and had waived the now famous "*Miranda* rights."[32] It appears that evidence derived from a statement excluded by *Miranda* will be inadmissible as "fruit of the

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[25]In Wolf v. Colorado, 338 U.S. 25 (1949), the Court held that the fourteenth amendment encompasses "the security of one's privacy against arbitrary intrusions by the police." *Id.* at 27.

[26]

> Finally the Court in [*Weeks*] clearly stated that use of the seized evidence involved "a denial of the constitutional rights of the accused." . . . This Court has ever since required of federal law officers a strict adherence to that command which this Court has held to be a clear, specific, and constitutionally required—even if judicially implied—deterrent safeguard without insistance upon which the Fourth Amendment would have been reduced to "a mere form of words."

367 U.S. at 648, *quoting from* Silverthorne Lumber Co. v. United States, 251 U.S. 385, 392 (1920) (Holmes, J.).

[27]Ker v. California, 374 U.S. 23 (1963).

[28]Katz v. United States, 389 U.S. 347 (1967).

[29]Berger v. New York, 389 U.S. 41 (1967).

[30]3 E. WHARTON, CRIMINAL EVIDENCE § 671, at 135 (Torcia rev. ed. 1972). Apparently at common law involuntary confessions and admissions were excluded by the beginning of the seventeenth century as a matter of evidentiary law. *See* Bram v. United States, 168 U.S. 532, 540-61 (1897); *cf.* 8 J. WIGMORE, EVIDENCE § 2266, at 401 (McNaughton rev. ed. 1961).

[31]384 U.S. 436 (1966).

[32]"Prior to any questioning, the person must be warned that he has the right to remain silent, that any statement he does make may be used as evidence against him, and that he has the right to the presence of an attorney, either retained or appointed." *Id.* at 484-85.

poisonous tree,"[33] but the question is not completely settled.[34]

The fifth amendment traditionally has been applied to exclude testimony given in a prior proceeding under a grant of immunity. In 1896 compulsion of testimony under such a grant was upheld against fifth amendment challenge.[35] Recently, the Court held that the witness need not be afforded immunity against prosecution for the transaction of which he testifies, but need only be protected against use of the testimony given and evidence derived from that testimony.[36]

The Court also recognized the dilemma of the defendant who seeks to suppress evidence seized in violation of the fourth amendment. To establish his standing to object to the evidence, defendant must testify to the existence and his possession of the evidence.[37] In 1968 such self-incriminatory testimony given in pretrial suppression hearings was held inadmissible at trial.[38]

Use of the exclusionary rule to implement the sixth amendment began in a number of cases decided in the 1960's. Statements given by a defendant against whom formal charges were pending, made in the absence of defendant's retained attorney, were declared inadmissible.[39] In *Escobedo v. Illinois*[40] the Court held that a statement made by a "particular suspect" upon whom an investigation had focused was inadmissible if the suspect requested and was denied an opportunity to consult his attorney. Statements given at a pretrial hearing at which the defendant was not represented by counsel were declared inadmissible at defendant's trial.[41]

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[33]*Id.* at 479; Orozco v. Texas, 394 U.S. 324 (1969); United States v. Cassell, 452 F.2d 533 (7th Cir. 1971); Sullins v. United States, 389 F.2d 985 (10th Cir. 1968).

[34]In Michigan v. Tucker, 417 U.S. 433 (1974), the Court, while finding it unnecessary to reach "the broad question of whether evidence derived from statements taken in violation of *Miranda* rules must be excluded regardless of when the interrogation took place," held that the testimony of a witness uncovered as result of a *Miranda*-violative statement need not be excluded when the interrogation (but not the trial) took place before *Miranda*, and when the violation consisted only of a failure to advise defendant of his right to counsel. *Id.* at 447. *See* Comment, *The Fruits of* Miranda: *Scope of the Exclusionary Rule*, 39 U. Colo. L. Rev. 478 (1967).

[35]Brown v. Walker, 161 U.S. 591 (1896), *reaffirmed in* Ullman v. United States, 350 U.S. 422 (1956).

[36]Kastigar v. United States, 406 U.S. 441 (1972).

[37]See text accompanying notes 78-82 *infra*.

[38]Simmons v. United States, 390 U.S. 377 (1968).

[39]Massiah v. United States, 377 U.S. 201 (1964).

[40]378 U.S. 478 (1964).

[41]Pointer v. Texas, 380 U.S. 400 (1965). *Pointer* was one of the first of many cases relying on the confrontation clause of the sixth amendment to exclude testimony not subject to cross-examination. *See* Berger v. California,

In 1967 the Court held that eyewitness identification of a charged defendant is a "critical stage" of the prosecution, at which the defendant is entitled to the presence of his attorney.[42] Exclusion of the identification was the remedy provided. An eyewitness identification obtained through an unnecessarily suggestive procedure violates due process and is to be excluded.[43] In 1972 the derivative evidence rule was held to exclude in-court identification when an invalid pretrial identification created a "very substantial likelihood of irreparable misidentification."[44]

Further, the Court has held that the record of prior felony convictions, which convictions are void under *Gideon v. Wainwright*[45] because defendant was not represented by counsel, are not admissible to impeach defendant's credibility,[46] to determine his liability for sentencing under a recidivist statute,[47] or to fix a convicted defendant's sentence.[48]

Finally, exclusion has been used to enforce the due process clause of the fourteenth amendment in its requirement of "fundamental fairness." In 1952, before exclusion of evidence seized in

393 U.S. 314 (1969); Roberts v. Russell, 392 U.S. 293 (1968); Bruton v. United States, 391 U.S. 123 (1968); Barber v. Page, 390 U.S. 719 (1968); Brookhart v. Janis, 384 U.S. 1 (1966); Douglas v. Alabama, 380 U.S. 415 (1965) (testimony excluded); *cf.* Mancusi v. Stubbs, 408 U.S. 204 (1972); Nelson v. O'Neil, 402 U.S. 622 (1971); Dutton v. Evans, 400 U.S. 74 (1970); California v. Green, 399 U.S. 149 (1970) (testimony admitted).

These cases are not further considered in this Note because they differ from those cases in which evidence is excluded due to the illegality of its procurement. In the "confrontation clause" cases, the evidence is excluded because its introduction would infringe the defendant's sixth amendment rights. Accordingly, these cases have developed separately and distinctly from the exclusionary rule cases in which the procurement of the evidence infringes defendant's constitutional rights.

In Coleman v. Alabama, 399 U.S. 1 (1970), the Court held that an adversary, evidentiary hearing to determine probable cause is a "critical stage" of the criminal process, at which defendant is entitled to the assistance of counsel. More recently, the Court held that a "full scale" hearing is not constitutionally required, and assistance of counsel is not required at less formal hearings. Gerstein v. Pugh, 420 U.S. 103 (1975). *Pointer* would still apply to exclude testimony given at a preliminary hearing at which defendant was not represented by counsel.

[42]United States v. Wade, 388 U.S. 218 (1967); Gilbert v. California, 388 U.S. 263 (1967).

[43]Stovall v. Denno, 388 U.S. 293 (1967). *Stovall* is based on the "fundamental fairness" requirement of the due process clause rather than the right to counsel.

[44]Neil v. Biggers, 409 U.S. 188, 197 (1972), *quoting from* Simmons v. United States, 390 U.S. 377, 384 (1968).

[45]372 U.S. 335 (1963).

[46]Loper v. Beto, 405 U.S. 473 (1972).

[47]Burgett v. Texas, 389 U.S. 109 (1967).

[48]United States v. Tucker, 404 U.S. 443 (1972).

violation of the fourth amendment was said to be mandated by the fourteenth amendment, the Court, in a case involving invasion of defendant's person by forced stomach pumping, held inadmissible any evidence obtained by official "conduct that shocks the conscience."[49]

III. Criticism of and Alternatives to the Rule

The exclusionary rule has never enjoyed unanimous support, and in recent years it has come under widespread attack by the public as well as by a number of judicial and scholarly commentators. Particularly criticized are those applications of the rule which "regulate" police behavior: the exclusion of evidence unlawfully seized and of statements given by defendants in custody.

The rule excluding evidence unlawfully seized—the *Weeks* rule as applied to federal courts and the *Mapp* rule as applied to state courts—has been criticized as ethically unjustifiable,[50] as entail-

[49]Rochin v. California, 342 U.S. 165 (1952). Since *Rochin*, blood tests have been held not to be "conduct that shocks the conscience." Breithaupt v. Abram, 352 U.S. 432 (1957). This is so even if the defendant is conscious and objects. Schmerber v. California, 384 U.S. 757 (1966).

The issue has recently surfaced in body cavity searches for narcotics by customs or border officials. The Ninth Circuit held that a doctor should have been summoned by a customs agent, who removed a heroin packet from the defendant's rectum. United States v. Carpenter, 496 F.2d 855 (9th Cir. 1974). *See also* Guy v. McCauley, 385 F. Supp. 193 (E.D. Wis. 1974).

[50]

> However much we may be revolted by the methods used by the police to obtain the evidence, we cannot rationally say that the defendant whose crime may be at least equally revolting should have a personal right to go free as a result.

Barrett, *Exclusion of Evidence Obtained by Illegal Searches*, 43 Calif. L. Rev. 565, 581 (1955).

> To be unable to find a murderer guilty, although competent evidence is before the court to warrant a conviction, for the reason that someone else is guilty of petit larceny in connection with the obtaining of such evidence, seems a handicap rather than a help to the administration of justice.

People v. Defore, 213 App. Div. 643, 652, 211 N.Y.S. 134, 142 (1925).

"On ethical grounds the rule in its most direct application seems unfair. It benefits only the guilty. . . . Further the application of the rule punishes society and not the offending officer." Brief for State of Illinois as Amicus Curiae, United States v. Robinson, 414 U.S. 218 (1973), *as quoted in* F. Inbau, J. Thompson, J. Haddad, J. Zagel & G. Starkman, Cases and Comments on Criminal Procedure 164 (1974).

The late Dean Wigmore delivered a famous attack on the "heretical influence of Weeks v. United States" as an "unnatural method" of enforcing the fourth amendment:

> Titus, you have been found guilty of conducting a lottery; Flavius, you have confessedly violated the Constitution. Titus ought to suffer imprisonment for crime, and Flavius for contempt. But no! We shall

ing undue social cost in terms of obstruction of the administration of justice,[51] and as an ineffective deterrent to violations of the fourth amendment.[52] The *Weeks* rule has been criticized as

> let you *both* go free. We shall not punish Flavius directly, but shall do so by reversing Titus' conviction. . . . Our way of upholding the Constitution is not to strike at the man who breaks it, but to let off somebody else who broke something else.

8 J. WIGMORE, EVIDENCE § 2184a, at 31 n.1 (McNaughton rev. ed. 1961) (emphasis in original).

All of these arguments seem to miss the point that the gravamen of the wrong sought to be remedied by exclusion is not the misdemeanor of the offending officer against the laws of the state, but the denial of a constitutional right personal to the defendant, committed by an agent of the state. This distinction is supported by the rule, under which governmental involvement is required to render illegally seized evidence inadmissible. See note 23 *supra*.

[51]

> The question is whether protection for the individual would not be gained at a disproportionate loss of protection for society. On the one side is the social need that crime shall be suppressed. On the other, the social need that law shall not be flouted by the insolence of office. There are dangers in any choice. The rule of the Adams Case strikes a balance between opposing interests.

People v. Defore, 242 N.Y. 13, 25, 150 N.E. 585, 589, *cert. denied*, 270 U.S. 657 (1926), *referring to* People v. Adams, 176 N.Y. 351, 68 N.E. 636 (1903) (denying exclusion).

[52]Before *Mapp*, a Northwestern University law student study of motions to suppress in Chicago, where the *Weeks* rule was in effect, People v. Castree, 311 Ill. 392, 143 N.E. 112 (1924), concluded that "the rule has failed to deter any substantial number of illegal searches . . ." and was particularly ineffective in minor offenses where illegal searches were utilized to disrupt illegal activities through harassment. Comment, *Search and Seizure in Illinois: Enforcement of the Constitutional Right to Privacy*, 47 NW. U.L. REV. 493, 497-98 (1952).

An empirical study by Columbia University law students in 1968 of misdemeanor narcotics arrests in New York City before and after *Mapp* suggests that the exclusionary rule produced police perjury rather than greater security for fourth amendment rights.

> In general the data indicate that police allegations as to how evidence was obtained changed after the *Mapp* decision. There is some indication, however, that police practices in the field have not changed substantially, and that police officers often merely fabricate testimony to avoid the effect of *Mapp*-based motions to suppress illegally seized evidence.

Comment, *Effect of* Mapp v. Ohio *on Police Practices in Narcotics Cases*, 4 COLUM. J.L. & SOCIAL PROB. 87 (1968).

In 1970 Professor Dallin Oaks published a study of, *inter alia*, motions to suppress in Cook County Circuit Court (Chicago) during 1969-1970, concluding that:

> [I]llegal searches and seizures were commonplace in the enforcement of gambling, narcotics, and weapons offenses by the Chicago police. [The statistics] also provide evidence that the exclusionary rule does not deter the Chicago police from making illegal searches and seizures in a large proportion of the cases that come to court in these crime areas.

not logically following from the precedents cited,[53] and as a reversal of a long-standing doctrine without explanation. The *Mapp*

Oaks, *Studying the Exclusionary Rule in Search and Seizure*, 37 U. CHI. L. REV. 665, 706-07 (1970).

Professor Oaks also studied Cincinnati Police Department records and concluded that "the exclusionary rule made no significant change in Cincinnati search and seizure practices in narcotics and weapons cases, but [the study] suggests a possible effect in gambling." *Id.* at 707.

A 1973 study of motions to suppress in preliminary hearings in the Cook County Circuit Court (Chicago) from 1950-1971 by James Spiotto reveals a "sharp increase in narcotics and gun cases." Spiotto, *Search and Seizure: An Empirical Study of the Exclusionary Rule and Its Alternatives*, 2 J. LEGAL STUDIES 243, 246 (1973).

> The increase in motions to suppress . . . can be traced at least in part to increased social pressure for aggressive enforcement in these areas. Still, had the exclusionary rule deterred police from making illegal search and seizures, one might expect the number of motions to suppress to have declined in all offenses . . . .

Id. at 248.

The same study also noted that some individual police officers were not deterred in the least.

> [D]uring June 1971, while 276 defendants in 172 Narcotics Court cases made motions to suppress, only 130 police officers were involved. Thus nine officers were responsible for 25 cases involving 34 defendants and in each of the 25 cases each of the officers repeated, within a one-month period, the same type of search practice that had already in that month been held unlawful by the court.

Id. at 276-77. It should be noted that some authorities doubt the validity of statistical studies in this matter because of the inadequacy of data available. LaFave, *Improving Police Performance Through the Exclusionary Rule—Part I*, 30 MO. L. REV. 391, 394 (1965).

Professor LaFave has commented on the pressures on the police to ignore fourth amendment requirements because of public opinion. The public expects the police to uncover evidence and make arrests. "There is no substantial corresponding public pressure upon the police to conform their activities with what the law on arrest, search, and seizure allows." *Id.* at 444-45. *See also* J. SKOLNICK, JUSTICE WITHOUT TRIAL 219-26 (1967).

It has been noted that the subtleties, inconsistencies, and constant changes in search and seizure law provide little enlightenment to the police officer who attempts to follow that law. Burns, Mapp v. Ohio: *An All-American Mistake*, 19 DEPAUL L. REV. 80 (1969). It has also been noted that there is no adequate communication of that law from the courts to the police. LaFave & Remington, *Controlling the Police: The Judge's Role in Making and Reviewing Law Enforcement Decisions*, 63 MICH. L. REV. 987, 1005 (1965).

Chief Justice Burger, dissenting in Bivens v. Six Unknown Named Agents, 403 U.S. 388 (1971), a civil action for damages against federal officers for an illegal search, criticized the exclusionary rule. He listed the following reasons for the rule's failure as a deterrent: (1) the absence of direct sanction against the offending officer, (2) the inability of the prosecutor, upon whom the actual sanction is imposed, to control police practices, (3) the lack of educational value of judicial review in apprising the police of acceptable search and seizure practices, and (4) the lack of deterrent value of exclusion in cases in which no prosecution results. *Id.* at 415-18.

doctrine has been attacked as being a federal judicial rule of evidence forced upon the states and a judicially-created set of rules of criminal procedure.[54]

Exclusion of self-incriminatory statements, particularly as required by *Miranda*, has also been widely criticized as being destructive of effective law enforcement,[55] as being constitutionally unsound,[56] and as being a usurpation of legislative power. The unpopularity of this rule with the public is well known[57] and led to a congressional disavowal of *Miranda* in Title II of the 1968 Omnibus Crime Control and Safe Streets Act.[58] The Act provides that in federal courts the criterion for admissibility is voluntariness; the giving of warnings is to be considered but is not conclusive in the determination of voluntariness.[59]

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[53] 8 J. WIGMORE, EVIDENCE § 2184a, at 31-34 (McNaughton rev. ed. 1961); *id* § 2264 n.4, at 381-84.

[54] "The majority treats the exclusionary rule as a judge-made rule of evidence designed and utilized to enforce the majority's own notions of proper police conduct. The Court today announces its new rules of police procedure in the name of the Fourth Amendment." Coolidge v. New Hampshire, 403 U.S. 443, 498-99 (1971) (Black, J., dissenting). *See also* Mapp v. Ohio, 367 U.S. 643, 678 (1961) (Harlan, J., dissenting).

[55] Miranda v. Arizona, 384 U.S. 436, 500 (1966) (Clark, J., dissenting); *id.* at 518-19 (Harlan, J., dissenting); *id.* at 542 (White, J., dissenting). *See also* S. REP. No. 1097, 90th Cong., 2d Sess. (1968).

Inbau and Reid argue that, in many criminal investigations, confessions obtained through interrogation are the only possible means of solving a crime and convicting the criminal:

> In many criminal investigations, even of the most efficient type, there are many, many instances where physical clues are entirely absent, and the only approach to a possible solution of the crime is the interrogation of the criminal suspect himself, as well as others who may possess significant information. Moreover, in most instances these interrogations, particularly of the suspect himself, must be conducted under conditions of privacy and for a reasonable period of time; and they frequently require the use of psychological tactics and techniques that could well be classified as "unethical" if we are to evaluate them in terms of ordinary, everyday social behavior.

F. INBAU & J. REID, CRIMINAL INTERROGATION AND CONFESSION 203 (1962).

[56] *See* Miranda v. Arizona, 384 U.S. 436, 506 (1966) (Harlan, J., dissenting); *id.* at 526 (White, J., dissenting).

[57] "The general public is becoming frightened and angered by the many reports of depraved criminals being released to roam the streets in search of other victims." S. REP. No. 1097, 90th Cong., 2d Sess. (1968).

[58] 18 U.S.C. § 3501 (1970).

[59] *Id.* provides in part:

> (a) In any criminal prosecution brought by the United States or by the District of Columbia, a confession, as defined in subsection (e) hereof, shall be admissible in evidence if it is voluntarily given. Before such confession is received in evidence, the trial judge shall, out of the presence of the jury, determine any issue as to voluntariness. . . .

A number of attempts have been made to find an acceptable alternative for the exclusionary rule as a remedy for constitutional guarantees, especially as regards unreasonable searches and seizures. An illegal search or seizure is, of course, a common law tort.[60] Moreover, under the Federal Civil Rights Act of 1871, one who deprives another of any constitutional right "under color of law" is liable in a civil action for damages.[61] However, these

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(b) The trial judge in determining the issue of voluntariness shall take into consideration all the circumstances surrounding the giving of the confession, including (1) the time elapsing between the arrest and arraignment of the defendant making the confession, if it was made after arrest and before arraignment, (2) whether such defendant knew the nature of the offense with which he was charged or of which he was suspected at the time of making the confession, (3) whether or not such defendant was advised or knew that he was not required to make any statement and that any such statement could be used against him, (4) whether or not such defendant had been advised prior to questioning of his right to the assistance of counsel, and (5) whether or not such defendant was without the assistance of counsel when questioned and when giving such confession.

The presence or absence of any of the above-mentioned factors to be taken into consideration by the judge need not be conclusive on the issue of voluntariness of the confession.

. . . .

(d) Nothing contained in this section shall bar the admission in evidence of any confession made or given voluntarily by any person to any other person without interrogation by anyone, or at any time at which the person who made or gave such confession was not under arrest or other detention.

(e) As used in this section, the term "confession" means any confession of guilt of any criminal offense or any self-incriminatory statement made or given orally or in writing.

As of this writing, the constitutionality of section 3501 has not been ruled upon. Most courts reviewing voluntariness determinations under this section have found no *Miranda* violations in cases in which the confession was found voluntary. *See, e.g.*, United States v. Vigo, 487 F.2d 295 (2d Cir. 1973).

The Tenth Circuit has recently held that Michigan v. Tucker, 417 U.S. 433 (1974), implicitly upheld section 3501 as constitutional. United States v. Crocker, 510 F.2d 1129, 1137 (10th Cir. 1975). See notes 88-94 & accompanying text *infra*.

[60]Entick v. Carrington, 19 How. St. Tr. 1029 (C.P. 1765), *cited in* Boyd v. United States, 116 U.S. 616, 626-30 (1886), was actually an action in trespass to recover £2000 damages for an unlawful search and seizure.

[61]42 U.S.C. § 1983 (1970) provides:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

remedies have generally proven inadequate. Problems of lack of jury sympathy,[62] judgment-proof police, and sovereign immunity of states preventing vicarious liability are obvious.[63] The federal remedy is further limited in usefulness in that it does not impose liability on municipalities or state governments.[64] Moreover, "good faith" belief by the officer in the lawfulness of his action is a defense in a civil action against him.[65] Similarly, an illegal search or seizure may be a crime, but criminal prosecutions for such crimes are very rare, "for the obvious reason that policemen and prosecutors do not punish themselves."[66]

Internal police discipline has been suggested as a remedy to prevent unlawful police activities, but suffers from the drawback that the primary duty of policemen is perceived to be the detection and apprehension of criminals, not adherence to the fourth amendment.[67] A streamlined tort claim process has been suggested by Chief Justice Burger[68] and by Edward Horowitz.[69] Each proposal involves a non-jury hearing before a tribunal composed of lawyers.[70] Horowitz, whose proposal is more detailed, suggests a measure of damages and a provision for appeal. Both plans entail a remedy against the governmental entity employing the offending officer. Such a process would meet many of the objections leveled at both the exclusionary rule and the presently available tort actions as effective remedies.

Chief Justice Burger has also suggested disciplinary action by a civilian review board against offending officers.[71] This al-

Section 1983 applies to unlawful searches and seizures. Monroe v. Pape, 365 U.S. 167 (1961).

[62]*See* Foote, *Tort Remedies For Police Violations of Individual Rights*, 39 MINN. L. REV. 493, 499-501 (1955). The author suggests that recovery is likely only for "the respectable plaintiff who can come into court with relatively clean hands." *Id.* at 500.

[63]*See* Greenhill & Murto, *Governmental Immunity*, 49 TEXAS L. REV. 462, 463-66 (1971).

[64]Monroe v. Pape, 365 U.S. 167 (1961) (municipalities); Williford v. California, 352 F.2d 474 (9th Cir. 1965) (states). *Cf.* Note, *Developing Governmental Liability Under 42 U.S.C. § 1983*, 55 MINN. L. REV. 1201 (1971).

[65]Pierson v. Ray, 386 U.S. 547 (1967).

[66]Foote, *supra* note 62, at 493.

[67]*Id.* at 494.

[68]Bivens v. Six Unknown Named Agents, 403 U.S. 388, 422-23 (1971) (Burger, C.J. dissenting).

[69]Horowitz, *Excluding the Exclusionary Rule*, 47 L.A. BAR BUL. 91, 94-99, 121-24 (1972).

[70]The Chief Justice envisioned the tribunal as "quasi-judicial in nature or perhaps patterned after the United States Court of Claims." Bivens v. Six Unknown Named Agents, 403 U.S. 388, 423 (1971) (Burger, C.J., dissenting). Horowitz suggests an "administrative or quasi-judicial body." Horowitz, *supra* note 69, at 94.

[71]Burger, *Who Will Watch the Watchman?*, 14 AM. U.L. REV. 1 (1964).

ternative may be subject to greater popular opposition than the exclusionary rule itself among those fearful of "handcuffing the police."[72] There are also questions as to such a board's effectiveness.[73]

Contempt of court has been suggested as a remedy against offending officers.[74] This remedy has the virtue of not depending upon prosecution or victim for institution of an action, but might amount to a denial of due process, since if the offending officer appears in court in the suspect's trial he would give evidence against himself upon a charge of which he has no notice.

Finally, a modified exclusionary rule which would restrict exclusion to flagrant and intentional violations of the fourth amendment has been proposed by Judge Friendly.[75]

In the area of self-incriminating statements, alternative remedies are available in fewer situations, but it appears that coercion of a confession can constitute a wrong actionable under the Civil Rights Act of 1871,[76] even when no physical abuse is involved.[77] Criminal sanctions are again available but seldom employed.

Whatever the merits of criticism of the exclusionary rule in its various applications, it is indisputable that disaffection with the rule has produced pressure for relief from its effects. The

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Chief Justice (then Circuit Judge) Burger's board would contain a minority of police members, have subpoena powers, act on both citizen complaints and court cases in which suppression is ordered, and hold hearings at which the assistance of counsel would be allowed. Judge Burger did not decide whether the board's disciplinary powers should be actual or advisory.

[72]*See* Barton, *Civilian Review Boards and the Handling of Complaints Against the Police*, 20 U. TORONTO L.J. 448, 460-63 (1970). The author refers to the John Birch Society pamphlet, "Support Your Local Police."

[73]*Id.* Judge Burger, in support of the efficacy of his suggestion, likened it to industrial and aviation accident injuiries and judicial review. Burger, *Who Will Watch the Watchman?*, 14 AM. U.L. REV. 1, 15, 20 (1964). Neither seems a compelling analogy.

[74]Blumrosen, *Contempt of Court and Unlawful Police Action*, 11 RUTGERS L. REV. 526 (1957). The procedure envisioned is a contempt citation which would take effect if the police authorities fail to take appropriate disciplinary action.

[75]Friendly, *The Bill of Rights as a Code of Criminal Procedure*, 53 CAL. L. REV. 929, 952 (1965). *See also* ALI MODEL CODE OF PRE-ARRAIGNMENT PROCEDURE § 8.02(2) (Tent. Draft No. 4, 1971). This proposal is similar to the "balancing test" between individual and societal interests undertaken by the courts in Scotland on a case-by-case basis to determine admissibility. *See* F. INBAU, J. THOMPSON, J. HADDAD, J. ZAGEL, & G. STARKMAN, CASES AND COMMENTS ON CRIMINAL PROCEDURE 169 (1974).

[76]Kerr v. City of Chicago, 424 F.2d 1134 (7th Cir.), *cert. denied*, 400 U.S. 833 (1970). See note 61 *supra*.

[77]Duncan v. Nelson, 466 F.2d 939 (7th Cir.), *cert. denied*, 409 U.S. 894 (1972).

limitations on and exceptions to the rule must be viewed in this light.

IV. Limitations on and Exceptions to the Rule

A. *Requirement of Standing*

As already noted, the exclusion of evidence is contingent upon successful challenge by the defendant.[78] In order to challenge admission of evidence, the defendant must establish standing: he must show that a right of his was violated by the acquisition of the evidence and not merely by its admission.[79] If the evidence objected to was obtained by unlawful search and seizure, defendant must have been in possession of or have had a proprietary interest in either the evidence itself or the premises searched.[80] Similarly, the confession of a co-defendant may not be challenged by defendant on the grounds of involuntariness and incrimination of defendant.[81] Generally a co-defendant cannot claim "derivative" standing through the defendant whose rights were violated.[82]

B. *Exceptions*

Even if defendant has standing to contest the admission of evidence and has done so by the proper procedure, evidence subject to suppression may still be used against him in several ways. As an investigative lead, the inadmissible evidence may uncover additional evidence; theoretically, this new evidence should be excluded as "fruit of the poisonous tree,"[83] but this is not always the case. Evidence derived from inadmissible evidence is not ex-

[78] *See* note 6 & accompanying text *supra*. *See generally* 2 J. Varon, Searches, Seizures, and Immunities 840-51 (2d ed. 1974).

[79] Alderman v. United States, 349 U.S. 165 (1969); Jones v. United States, 362 U.S. 257 (1960). It has been held a violation of the defendant's sixth amendment rights when admissions or confessions by co-defendants are admitted into evidence at a joint trial without these defendants taking the stand. Bruton v. United States, 391 U.S. 123 (1968). Here, however, the admission itself infringes the defendant's right to confront witnesses against him. *See* note 41 *supra*.

[80] Brown v. United States, 411 U.S. 223 (1973). In Jones v. United States, 362 U.S. 257 (1960), distinctions between proprietary interests were held irrelevant to standing; anyone legitimately on the premises searched has standing to challenge the evidence. *Jones* also created "automatic standing" when possession of the evidence sought to be suppressed is an essential element of the offense charged. In *Brown*, however, it was suggested that the rule of Simmons v. United States, 390 U.S. 377 (1968), excluding incriminatory statements made by a defendant at the suppression hearing, may have made "automatic standing" unnecessary.

[81] United States *ex rel.* Falconer v. Pate, 319 F. Supp. 206 (N.D. Ill. 1970); People v. Varnum, 66 Cal. 2d 808, 427 P.2d 772, 59 Cal. Rptr. 108 (1967); People v. Denham, 41 Ill. 2d 1, 241 N.E.2d 415 (1968).

[82] Combs v. United States, 408 U.S. 224 (1972).

[83] Silverthorne Lumber Co. v. United States, 251 U.S. 385 (1920).

cluded if the connection between the original and the derivative evidence has "become so attenuated as to dissipate the taint."[84] Moreover, if the new evidence is connected to the original inadmissible evidence but derives from an "independent source," it is admissible.[85] As Justice Marshall noted in his dissent in *Kastigar v. United States*,[86] difficulty in proving that the offered evidence was derived from the excluded evidence, because the defendant is not privy to the prosecution's investigation, renders the "fruit of the poisonous tree" doctrine "a loose net to trap tainted evidence."[87]

Some cases have held that witnesses discovered as a result of a constitutional violation are not precluded from testifying because of their relationship to the illegal source.[88] In 1974 the Supreme Court decided *Michigan v. Tucker*,[89] in which a witness, discovered through a statement obtained without adequate *Miranda* warnings, was allowed to testify against a defendant who was interrogated before, but tried after, *Miranda*. The Court held that this did not violate the defendant's fifth, sixth, or fourteenth amendment rights, but the reason for the decision is unclear. The Court expressly declined to decide whether the derivative evidence rule is generally applicable to *Miranda* statements[90] but intimated that *Miranda* violations may not be sufficiently serious infringements to invoke the rule.[91] Justice Rehnquist's majority opinion noted that exclusion of the witness' testimony would not serve to deter future *Miranda* violations because the instant violation was committed in good faith.[92] Justice Rehnquist said that a second basis for exclusion of involuntary statements is untrustworthiness, so that there is no reason to exclude the admittedly reliable witness' testimony.[93] Finally, he relied on *Harris v. New York*[94] as authority for the proposition that *Miranda* did not completely

[84]Nardone v. United States, 308 U.S. 338, 341 (1939).

[85]Costello v. United States, 365 U.S. 265 (1961).

[86]406 U.S. 441, 467 (1972) (Marshall, J., dissenting).

[87]*Id.* at 469.

[88]United States v. Tane, 329 F.2d 848 (2d Cir. 1964); People v. Eddy, 349 Mich. 637, 85 N.W.2d 117 (1957), *cert. denied*, 356 U.S. 918 (1958). *See also* Smith v. United States, 324 F.2d 879 (D.C. Cir. 1963) (witness discovered in violation of *McNabb-Mallory* rule allowed to testify).

[89]417 U.S. 433 (1974).

[90]*Id.* at 447.

[91]*Id.* at 445-46.

[92]*Id.* at 447-48. Generally the good faith of the officer committing the violation does not prevent exclusion. See note 4 *supra*.

[93]*Id.* at 449. *Cf.* Jackson v. Denno, 378 U.S. 368 (1964); McCormick's Handbook of the Law of Evidence § 165, at 365 (2d ed. E. Cleary 1972). Justice Rehnquist dismisses the "judicial integrity" rationale as "an assimilation of the more specific rationales." 417 U.S. at 450.

[94]401 U.S. 222 (1971). See notes 106-11 & accompanying text *infra*.

preclude the use of statements obtained in violation of that decision. Thus, while *Tucker* provides some support for the existence of a "witness exception," it falls short of firmly establishing such an exception and of clearly defining the scope of *Miranda's* exclusionary rule.[95]

C. The Impeachment Exception

The most important exception, however, allows use of otherwise inadmissible evidence to impeach a defendant's credibility. The Supreme Court first considered such an exception in 1925 in *Agnello v. United States*,[96] a prosecution for conspiracy to sell cocaine illegally. Federal agents had unlawfully seized some cocaine from the defendant's room. On direct examination, the defendant was not asked about the cocaine in his room, but, on cross-examination, "he said he had never seen narcotics."[97] The prosecutor then showed him the cocaine seized in his room and asked him if he had ever seen it, to which the defendant answered negatively. The prosecution was then allowed to introduce the cocaine and testimony as to its seizure. The Court reversed the defendant's conviction, holding that unlawfully seized evidence is not admissible to impeach a defendant by rebutting a statement made on cross-examination.

However, in *Walder v. United States*,[98] a defendant denied on direct examination that he had ever possessed narcotics, and the trial court's admission of a heroin capsule illegally seized from the defendnt in a prior arrest was permitted to impeach the defendant by rebutting his denial. *Agnello* was distinguished on two grounds. First, the statement rebutted in *Walder* was not "forced" from defendant by a question on cross-examination. Secondly, in *Agnello* the impeachment evidence bore directly on defendant's guilt in the offense charged, while in *Walder* it dealt with a collateral issue. Justice Frankfurter, writing for the *Walder* majority, said:

> It is one thing to say that the Government cannot make an affirmative use of evidence unlawfully obtained. It is quite another to say that the defendant can turn the illegal method by which evidence in the Government's possession was obtained to his own advantage, and pro-

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[95]Justice Brennan suggested that *Tucker* could be resolved by holding that *Miranda* did not apply to interrogations conducted before the decision. 417 U.S. at 458 (Brennan, J., concurring).

[96]269 U.S. 20 (1925).

[97]*Id.* at 29.

[98]347 U.S. 62 (1954).

vide himself with a shield against contradiction of his untruths.[99]

For years the lower courts applied the *Walder* decision without extending it. The decision was generally interpreted as allowing rebuttal of perjurous statements made on direct examination relating to matters collateral to the issue of a defendant's guilt.[100] There was some doubt as to whether a statement inadmissible under *Miranda* could be so used, especially in view of language in *Miranda* suggesting otherwise.[101]

In the Court of Appeals for the District of Columbia Circuit, however, Judge Warren Burger found *Walder* a strong precedent. In 1960 in *United States v. Tate,*[102] the court, in an opinion by Judge Burger, held that statements which *United States v. McNabb*[103] would otherwise exclude were admissible to impeach a defendant by rebutting his testimony denying commission of the offense. In 1967 the same court decided *Woody v. United States,*[104] and Judge Burger, writing for the majority, said that when a defendant at trial denies making any statement to the police, he cannot then demand a suppression hearing to determine the voluntariness of a statement introduced at trial. In dictum the court said that incriminating statements made at a suppression hearing would be admissible at trial to rebut inconsistent testimony given by a defendant. That same year, in *Gordon v. United States,*[105] Judge Burger wrote that testimony given by a defendant at a hearing to determine the admissibility of a prior conviction would be admissible to impeach the defendant. Thus, Judge Burger showed a willingness to expand *Walder* into new areas of the exclusionary rule and exhibited a disregard for the *Walder-Agnello* distinctions.

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[99]*Id.* at 65.

[100]Groshart v. United States, 392 F.2d 172 (9th Cir. 1968); Wheeler v. United States, 382 F.2d 998 (10th Cir. 1967); Inge v. United States, 356 F.2d 345 (D.C. Cir. 1966); White v. United States, 349 F.2d 965 (D.C. Cir. 1965); Johnson v. United States, 344 F.2d 163 (D.C. Cir. 1964); Jackson v. United States, 311 F.2d 686 (5th Cir. 1963). *Cf.* United States v. Curry, 358 F.2d 904 (2d Cir. 1966).

[101]The *Miranda* Court stated that "unless and until such warnings and waiver are demonstrated by the prosecution at trial, no evidence obtained as a result of interrogation may be used against [the defendant]." 384 U.S. at 479. *See also* Bosley v. United States, 426 F.2d 1257 (D.C. Cir. 1970); Proctor v. United States, 404 F.2d 819 (D.C. Cir. 1968); United States v. Fox, 403 F.2d 97 (2d Cir. 1968); Commonwealth v. Padgett, 428 Pa. 229, 237 A.2d 209 (1968).

[102]283 F.2d 377 (D.C. Cir. 1960). *See also* Lockley v. United States, 270 F.2d 915, 918 (D.C. Cir. 1959) (Burger, J., dissenting).

[103]318 U.S. 332 (1943). See note 2 *supra.*

[104]379 F.2d 130 (D.C. Cir. 1967).

[105]383 F.2d 936 (D.C. Cir. 1967).

In 1971, when Judge Burger had become Chief Justice Burger, and the composition of the Court had greatly changed from that of the late 1960's, the Court decided the case of *Harris v. New York.*[106] The defendant, charged with the sale of heroin, took the stand and denied making the sale. On cross-examination, the prosecutor asked the defendant if he had given the police a statement. When the defendant said he did not remember, the prosecutor read to him from the statement, which was then admitted on defendant's motion. The trial court instructed the jury that the statement should be considered only in assessing the defendant's credibility and not as direct evidence of his guilt. The defendant appealed his conviction, arguing that allowing the prosecutor to use the statement, which violated *Miranda* but was not claimed to be involuntary, was reversible error.

The Court, in an opinion by the Chief Justice, held that the statement was admissible to impeach the defendant by rebutting the inconsistent statement on direct examination that he had not sold the heroin. The opinion dismissed the *Miranda* language as dictum[107] and, quoting the *Walder* Court's statement that a defendant should not be allowed to use the illegality of the government's action to "provide himself with a shield against contradiction of his untruths,"[108] said that the direct-collateral distinction in *Walder* was immaterial to the rationale of that case, which the Chief Justice apparently saw as prevention of perjury.[109] The Court effectively abolished the other *Walder* distinction as well: the defendant's denial of the sale on direct examination was the "perjury" which the statement was admitted to rebut. *Harris* has been much criticized,[110] but in 1973 the Court denied certiorari in a case in which *Harris* could have been limited.[111]

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[106]401 U.S. 222 (1971).

[107]*Id.* at 224. See note 101 *supra.*

[108]401 U.S. at 224, *quoting from* Walder v. United States, 347 U.S. 62, 65 (1954).

[109]401 U.S. at 224.

[110]Dershowitz & Ely, Harris v. New York: *Some Anxious Observations on the Candor and Logic of the Emerging Nixon Majority,* 80 YALE L.J. 1198 (1971); Kent, Harris v. New York: *The Death Knell of* Miranda *and* Walder?, 38 BROOKLYN L. REV. 357 (1971); 25 ARK. L. REV. 190 (1971); 23 BAYLOR L. REV. 639 (1971); 48 CHI.-KENT L. REV. 124 (1971); 40 FORDHAM L. REV. 394 (1971); 39 GEO. WASH. L. REV. 1241 (1971); 85 HARV. L. REV. 44 (1971); 49 TEXAS L. REV. 1119 (1971).

Before *Harris,* several commentators wrote that *Miranda* should be read as forbidding impeachment use of *Miranda*-violative statements. Kent, Miranda v. Arizona—*The Use of Inadmissible Evidence for Impeachment Purposes,* 18 W. RES. L. REV. 1177 (1967); Comment, *The Impeachment Exception to the Exclusionary Rules,* 34 U. CHI. L. REV. 939 (1967).

[111]Burt v. New Jersey, 475 F.2d 234 (3d Cir.), *cert. denied,* 414 U.S. 938

In March of 1975, the Supreme Court decided *Oregon v. Hass,*[112] applying the principles of *Harris* to a statement given after the defendant, who was in custody, had requested to be allowed to call his attorney, and before the attorney was called.[113] The Oregon Supreme Court had held that such a statement could not be used to impeach the defendant.[114] The United States Supreme Court reversed, holding that the fourth and fourteenth amendments did not preclude impeachment use of the statement,[115] although *Miranda* had held that such statements would be inadmissible in the prosecution's case-in-chief.[116] The Court's opinion, by Justice Blackmun, relied on *Harris* and found that the requirements for admissibility for impeachment purposes established in *Harris* were present in *Hass.*[117] The trustworthiness of the statement satisfied legal standards, as in *Harris.*[118] The material used to impeach "undoubtedly provided valuable aid to the jury in assessing petitioner's credibility," and the "benefits of this process should not be lost."[119] Finally, as in *Harris,* the deterrence rationale was found to be sufficiently served by exclusion of the statement from the prosecution's case-in-chief.[120]

(1973). Relying on *Harris,* the Third Circuit Court of Appeals concluded that it was not error to allow rebuttal of defendant's exculpatory testimony by testimony of his failure to tell his story to the police.

[112]95 S. Ct. 1215 (1975).

[113]Hass was arrested for the first-degree burglary of a garage from which a bicycle was stolen. After his arrest and the giving of *Miranda* warnings, he admitted to the arresting officer that he had possessed a stolen bicycle. Hass then asked to telephone his attorney and was told he could do so when they reached police headquarters. Before the attorney was called, Hass admitted knowing that the bicycle was stolen from a residence and pointed out to the officer the residence from which he thought it was taken.

The trial court admitted Hass' first statement but excluded the statement made after the request for his attorney. Hass testified, denying knowledge that the bicycle had been taken from a residence, and the State was allowed to rebut this denial with Hass' admission of such knowledge made after the request for counsel. An instruction was given limiting use of this testimony to impeachment of Hass' credibility. *Id.* at 1217-18.

[114]Oregon v. Haas, 267 Ore. 489, 517 P.2d 671 (1973).

[115]95 S. Ct. at 1221. Justice Marshall, in dissent, urged that it was not clear from the opinion of the state court whether federal or state law was relied upon to prohibit impeachment use of the statement, and that therefore the decision of the Oregon Supreme Court should be affirmed as resting on adequate state grounds. 95 S. Ct. at 1222 (Marshall, J., dissenting). *See* California v. Krivda, 409 U.S. 33 (1972); Department of Mental Hygiene v. Kirchner, 380 U.S. 194 (1965); Herb v. Pitcairn, 324 U.S. 117 (1945).

[116]384 U.S. at 474.

[117]95 S. Ct. at 1220-21.

[118]*Id.* at 1221. *See* Harris v. New York, 401 U.S. 222, 224 (1971).

[119]95 S. Ct. at 1120, *quoting from* Harris v. New York, 401 U.S. 222, 225 (1971).

[120]95 S. Ct. at 1220.

Justice Brennan, in dissent, argued that this application of the *Harris* rule effectively removed all incentive for the police to comply with a prisoner's request for counsel, since most attorneys would simply advise their clients to say nothing at all. A statement obtained in the absence of the requested counsel, on the other hand, is at least admissible for impeachment.[121] The majority termed this a "speculative possibility."[122] Thus, the Court, in an opinion joined by six justices, affirmed *Harris* in theory and in practice.[123]

V. The Future of the Exclusionary Rule

The courts of appeals have not only followed *Harris* in similar situations but, relying on the combination of *Harris* and *Walder*, have expanded the impeachment exception to virtually all the applications of the exclusionary rule.[124] The state courts have seized upon *Harris* as a means of mitigating the unwelcome effects of *Miranda* and, in some cases, of *Mapp*.[125]

In June of 1974 the Court of Appeals for the Seventh Circuit decided *United States v. Tweed*.[126] In that case the defendant was charged with possession of dynamite and on direct examination testified that he had never handled or carried any dynamite. In rebuttal the government introduced the testimony of a forensic chemist to the effect that traces of chemicals indicative of dynamite were found on defendant's illegally seized clothing. The appellate court held that the trial court correctly admitted the testimony. *Tweed* was similar to *Walder*, except that the rebuttal evidence strongly tended to prove defendant's guilt.

In September of 1974 the Supreme Court of Illinois held in *People v. Sturgis*[127] that a statement filed by the defendant in

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[121] *Id.* at 1221.

[122] *Id.*

[123] Justices Brennan and Marshall dissented. Justice Douglas took no part in *Hass*, but was among the dissenters in *Harris*. Thus, the majority in *Hass* included four members of the majority in *Harris*: the Chief Justice and Justices Stewart, White, and Blackmun. The two new members of the Court since *Harris*, Justices Powell and Rehnquist, completed the *Hass* majority. Justice Harlan, who was in the majority in *Harris*, and Justice Black, who dissented, both retired in September of 1971.

[124] United States v. James, 493 F.2d 323 (2d Cir. 1974); United States v. Purin, 486 F.2d 1363 (2d Cir. 1973); Roland v. Michigan, 475 F.2d 892 (6th Cir. 1973); United States v. McQueen, 458 F.2d 1049 (3d Cir. 1972).

[125] No attempt will be made here to catalogue the state decisions following *Harris*. The Supreme Court of Hawaii has rejected *Harris*. State v. Santiago, 53 Hawaii 254, 492 P.2d 657 (1971).

[126] 503 F.2d 1127 (7th Cir. 1974).

[127] 58 Ill. 2d 211, 317 N.E.2d 545 (1974). Apparently, more than mere de-

support of a motion to suppress was admissible to rebut the defendant's denial of guilt of the offense charged. Thus, the Illinois court adopted Judge Burger's conclusion in *Woody v. United States*[128] and overruled its own contrary holding in *People v. Luna*,[129] rendered at about the same time as *Woody*.

Relying on *Harris*, several courts have held that a defendant may be impeached by his silence in custody: if the defendant makes exculpatory statements on the stand, he may be impeached by testimony or questions regarding his failure to tell the police this story.[130] *Miranda* prohibits comment on a suspect's silence in custody,[131] but these courts have evidently considered such silence to be equivalent to an inconsistent statement with which defendant may be impeached.[132]

Another controversy arising in the wake of *Harris* regards impeachment by prior convictions which were invalid because defendant was denied assistance of counsel. The Supreme Court, in *Loper v. Beto*,[133] decided after *Harris*, held that such convictions were inadmissible for general impeachment purposes. The Court did not decide whether they could be used to rebut defendant's specific denials of prior convictions.[134] In 1971 the Court of Appeals for the Second Circuit held that such convictions could be used for such rebuttal.[135] Before *Harris*, the First and Ninth Cir-

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nial of commission of the offense is necessary to allow impeachment use of tangible evidence seized in violation of the fourth amendment. Some statement must be made on direct examination that can be rebutted by the evidence. United States v. Trejo, 501 F.2d 138, 143-46 (9th Cir. 1974).

[128]379 F.2d 130 (D.C. Cir. 1967). See text accompanying note 104 *supra*.

[129]37 Ill. 2d 299, 226 N.E.2d 586 (1967).

[130]Burt v. New Jersey, 475 F.2d 234 (3d Cir.), *cert. denied*, 414 U.S. 938 (1973); United States v. Ramirez, 441 F.2d 950 (5th Cir.), *cert. denied*, 404 U.S. 869 (1971).

[131]

> In accord with our decision today, it is impermissible to penalize an individual for exercising his Fifth Amendment right when he is under police custodial interrogation. The prosecution may not, therefore, use at trial the fact that he stood mute . . . in the face of accusation.

384 U.S. at 468 n.37. This statement is technically dictum, since none of the cases involved in *Miranda* involved use of defendant's silence.

[132]*Cf.* United States v. Hale, 95 S. Ct. 2133 (1975), *aff'g* United States v. Anderson, 408 F.2d 1038 (D.C. Cir. 1974). The Court held silence of an accused in custody is not "inconsistent" so as to allow the impeachment of a defendant by evidence of such silence. The Court did not reach the issue of the constitutionality of such impeachment. *See also* Deats v. Rodriguez, 477 F.2d 1023 (10th Cir. 1973); Johnson v. Patterson, 475 F.2d 1066 (10th Cir. 1973) (impeachment admission of testimony of silence held error).

[133]405 U.S. 473 (1972).

[134]*Id.* at 482 n.11.

[135]United States *ex rel.* Walker v. Follette, 443 F.2d 167 (2d Cir. 1971). The Fifth Circuit followed *Walker* in United States v. Nadaline, 471 F.2d

cuits had held to the contrary,[136] and, since *Harris*, the Ninth Circuit has reaffirmed its decision.[137]

The only applications of the exclusionary rule to which the impeachment exception have at this time apparently not been applied are immunized testimony and identification testimony. In 1973 the Court of Appeals for the Third Circuit distinguished *Harris* and held that testimony given under a grant of immunity could not be used to rebut an inconsistent assertion by defendant at his trial for perjury.[138] No cases limiting the exclusion of eyewitness identification due to the absence of counsel or suggestive procedure are reported.

In all cases in which otherwise inadmissible evidence is used to impeach defendant, such evidence is admissible only to aid in the determination of defendant's credibility, and the jury is instructed accordingly.[139] However, notwithstanding the Supreme Court's confidence in the efficacy of the limiting instruction,[140] it seems unrealistic to assume that the jury members, being human, could believe that defendant's confession of murder makes him a liar but not a murderer.[141]

The impeachment exception, as developed in *Harris* and following cases, has left a curious imbalance in the exclusionary rule. A defendant may still have evidence suppressed if it was obtained in any of the circumstances invoking the exclusionary rule. In many cases of minor offenses, particularly those involving drug possession, the unavailability of this evidence is fatal to the prosecution's case, and dismissal results.[142] Thus, *Harris* has not answered any of the salient criticisms of the rule. Reliable evidence procured in good faith through a slight or technical infringement of a constitutional guarantee remains inadmissible.

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340 (5th Cir. 1973), and Williams v. Wainwright, 502 F.2d 1115 (5th Cir. 1974). The Seventh Circuit followed *Walker* in United States v. Jansen, 475 F.2d 312 (7th Cir. 1973).

[136]Gilday v. Scafati, 428 F.2d 1027 (1st Cir. 1970), *cert. denied*, 400 U.S. 926 (1971); Tucker v. United States, 431 F.2d 1292 (9th Cir. 1970).

[137]Howard v. Craven, 446 F.2d 586 (9th Cir. 1971).

[138]United States v. Hockenberry, 474 F.2d 247 (3d Cir. 1973).

[139]*But see* United States *ex rel.* Wright v. LaVallee, 471 F.2d 123 (2d Cir. 1972) (admission of incriminating statement upheld despite lack of limiting instruction).

[140]*See* Nelson v. O'Neil, 402 U.S. 622 (1971). *But cf.* Bruton v. United States, 391 U.S. 123 (1968).

[141]Several commentators have expressed doubt as to the effectiveness of the limiting instruction. H. KALVEN & H. ZEISEL, THE AMERICAN JURY 171-80 (1966); MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 59, at 136 (2d ed. E. Cleary 1972); Note, *The Limiting Instruction—Its Effectiveness and Effect*, 51 MINN. L. REV. 264 (1967).

[142]Oaks, *Studying the Exclusionary Rule in Search and Seizure*, 37 U. CHI. L. REV. 665, 684-87 (1970).

However, if defendant proceeds to trial, he is faced with a choice between relinquishing his right to testify in his own behalf and "waiving" exclusion, since the prosecution can use the illegally obtained evidence to rebut his denial of the commission of the offense charged.[143]

Thus, *Harris,* born undoubtedly of dissatisfaction with applications of the exclusionary rule when reliable evidence is excluded because of minor infringements of constitutional rights, results in the sole criterion of admissibility being defendant's choice to testify. This circumvention of the rule remedies none of its defects while effectively sabotaging its purposes of deterrence and maintenance of judicial integrity.[144]

It is submitted that if the purposes of the exclusionary rule are to retain validity, the impeachment exception must be limited in two respects. First, impeachment use should be restricted to trustworthy evidence. Whenever unreliability was a factor in establishing the rule excluding certain evidence, that evidence should not be admissible to impeach. Recognition of this limitation appears implicitly in *Harris.* Chief Justice Burger noted that Harris' statement was not claimed to be involuntary and in-

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[143]Burt v. New Jersey, 414 U.S. 938 (1973) (Douglas, J., dissenting from order denying certiorari).

Justice Brennan, dissenting in *Harris,* said:

> The choice of whether to testify in one's own defense must . . . be "unfettered," since that choice is an exercise of the constitutional privilege . . . . The . . . prosecution's use of the tainted statement "cuts down on the privilege by making its assertion costly."

401 U.S. at 230, *quoting from* Griffin v. California, 380 U.S. 609, 614 (1965). *See also* Brooks v. Tennessee, 406 U.S. 605 (1972) (statute requiring a defendant who testifies in his own behalf to do so before other defense witnesses invalidated as impermissible restriction on defendant's fifth and sixth amendment rights).

[144]*Harris* is typical of the present Court's indirect attacks on the exclusionary rule. The Court has limited the scope of the constitutional rights which exclusion is used to enforce. *See* United States v. Robinson, 414 U.S. 218 (1973) (fourth amendment does not ban warrantless search incident to custodial arrest for traffic violation); United States v. Ash, 413 U.S. 300 (1973) (sixth amendment does not require that defendant's counsel be present at photographic identification); Adams v. Williams, 407 U.S. 143 (1972) (fourth amendment allows "stop-and-frisk" based on informant's tip); Kirby v. Illinois, 406 U.S. 682 (1972) (sixth amendment does not require exclusion of eyewitness identification made in absence of defendant's counsel unless formal charges pending against defendant); Wyman v. James, 400 U.S. 309 (1971) (fourth amendment allows requirement of consent to caseworker "home visits" as prerequisite to receiving benefits under Aid to Families with Dependent Children). The Court has also restricted the availability of exclusion. *See* United States v. Calandra, 414 U.S. 338 (1973) (witness cannot object to Grand Jury question as based on illegally obtained evidence); Lego v. Twomey, 404 U.S. 477 (1972) (prosecution need prove voluntariness of confession only by preponderance of evidence).

timated that an involuntary statement would not be admissible even for impeachment.[145] If *Harris* was meant to prevent exclusion from being "perverted into a license to use perjury by way of defense,"[146] then its exception should also be limited to evidence which *shows* perjury by its clear probative value.

If evidence subject to exclusion were placed on a continuum according to reliability, tangible evidence unlawfully seized or derived from unlawful acts would probably be considered the most reliable. Statements given at pretrial hearings are also considered trustworthy, as is testimony of witnesses derived from deprivations of rights. *Miranda*-violative statements are less reliable, and coerced statements even less so. Least reliable of all would be eyewitness identifications.[147] At some point on this continuum, a limit should be imposed beyond which the suppressed evidence is insufficiently reliable to invoke the impeachment exception. Since *Harris* has held admissible statements obtained in violation of *Miranda*, the limit would seem best placed there, excluding less reliable evidence such as coerced confessions and invalid eyewitness identifications.

Secondly, the exception should distinguish according to the gravity of the infringement of defendant's rights by which the evidence was obtained. This limitation is not explicitly recognized in *Harris*, but it may well be significant that the *Miranda* violation in that case was not a flagrant deprivation of Harris' rights. Further support for such a distinction may be found in *Michigan v. Tucker*,[148] where the slightness of the infringement, a *Miranda*-violative interrogation, was offered as a factor supporting the admissibility of the testimony of the witness to whom defendant's statement led.

Some sixty years ago the Supreme Court recognized that the mere existence of constitutional provisions would not alone secure the rights which those provisions guaranteed.[149] Whatever its defects, the exclusionary rule has served to vindicate these guarantees. It is to be hoped that rather than emasculate the rule by further indirect attacks, the Court will limit the impeachment exception so as to protect the exclusionary rule's ability to implement the Constitution.

DAVID JOEST

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[145] 401 U.S. at 225-26. *See* LaFrance v. Bohlinger, 499 F.2d 21, 35 (1st Cir. 1974).

[146] 401 U.S. at 226.

[147] *See* United States v. Wade, 388 U.S. 218 (1967).

[148] 417 U.S. 433 (1974). See text accompanying notes 88-94 *supra*.

[149] Weeks v. United States, 232 U.S. 383 (1914). See note 4 *supra*.

Recent Development

Constitutional Law—FIRST AMENDMENT—United States Supreme Court held that the first amendment protected an abortion advertisement which conveyed information of potential interest to an audience, despite its appearance in the form of a paid commercial advertisement.—*Bigelow v. Virginia*, 95 S. Ct. 2222 (1975).

An attack on the constitutionality of a Virginia statute,[1] which prohibited publication of items which would encourage the procurement of an abortion, afforded the United States Supreme Court an opportunity to limit the scope of "commercialism." Prior cases held that commercial advertisements were not covered under the guarantees of the first amendment.[2] In *Bigelow v. Virginia*,[3] the Court expanded the scope of the protected rights of the first amendment by redefining "commercialism" to exclude advertisements which contain "factual material of clear 'public interest.'"[4]

On February 8, 1971, the *Virginia Weekly*[5] contained an advertisement for Women's Pavilion, a New York City abortion referral and placement center. The advertisement included an opening statement that abortions "are now legal in New York" with "no residency requirements."[6] This was followed by an

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[1]Act of March 30, 1960, ch. 358, § 18.1-63, [1960] Va. Acts 428 (repealed by amendment 1972). See text of present statute at note 23 *infra*.

[2]*See, e.g.*, Head v. New Mexico Bd., 374 U.S. 424 (1963); Breard v. Alexandria, 341 U.S. 622 (1951); Packer Corp. v. Utah, 285 U.S. 105 (1932).

[3]95 S. Ct. 2222 (1975).

[4]*Id.* at 2232, *quoting from* Valentine v. Chrestensen, 316 U.S. 52, 54 (1942).

[5]The *Virginia Weekly*, published by Virginia Weekly Associates of Charlottesville, has its major focus on the University of Virginia campus. Appellant Bigelow described the publication as an "underground newspaper." Brief for Appellant at 3, Bigelow v. Virginia, 95 S. Ct. 2222 (1975).

[6]The entire advertisement appeared as follows:

UNWANTED PREGNANCY
LET US HELP YOU
Abortions are now legal in New York.
There are no residency requirements.
FOR IMMEDIATE PLACEMENT IN ACCREDITED
HOSPITALS AND CLINICS AT LOW COST
Contact
WOMEN'S PAVILION

offer of immediate placement in accredited hospitals and clinics upon contacting the given New York address or phone numbers. Jeffrey Bigelow, the managing editor of this publication, was charged with violating the Virginia statute by publishing material which would encourage procurement of an abortion.[7]

Bigelow's contest of this misdemeanor in the County Court of Albemarle County was to no avail. In a de novo trial, the circuit court reached the same decision as the county court.[8] This was affirmed by the Virginia Supreme Court which held that the advertisement was not within the scope of protected rights under the first amendment.[9] The Court excluded this case from the blanket protection of "freedom of speech and press" due to the doctrine often referred to as "commercialism."[10] When an activity is of a purely commercial nature, there is no standing to claim a legitimate first amendment interest.[11] Since this advertisement "constituted an active offer to perform a service, rather than a passive statement of fact,"[12] it exceeded the permissible informational status. The court further held Virginia's statute valid as an exercise of the State's police power by finding a reasonable state interest "to ensure that pregnant women in Virginia who decided to have abortions come to their decisions without the commercial advertising pressure usually incidental to the sale of a box of soap powder."[13]

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515 Madison Avenue
New York, N.Y. 10022
or call any time
(212) 371-6670 or (212) 371-6650
AVAILABLE 7 DAYS A WEEK
STRICTLY CONFIDENTIAL. We will make
all arrangements for you and help you
with information and counseling.

Virginia Weekly, Feb. 8, 1971, at 2 *quoted in* 95 S. Ct. at 2227.

[7] [I]f any person, by publication, lecture, advertisement, or by the sale or circulation of any publication, or in any other manner, encourage or prompt the procuring of abortion or miscarriage, he shall be guilty of a misdemeanor.

Act of March 30, 1960, ch. 358, § 18.1-63, [1960] Va. Acts 428 (repealed by amendment 1972). See text of present statute at note 23 *infra*.

[8] A Virginia statute allows de novo review on appeal to the circuit court from the county court. Va. Code Ann. §§ 16.1-132,-136 (1960).

[9] Bigelow v. Commonwealth, 213 Va. 191, 191 S.E.2d 173 (1972) (4-2 decision).

[10] *See* 60 Va. L. Rev. 154 (1974).

[11] *See* 78 Harv. L. Rev. 1191 (1965).

[12] Bigelow v. Commonwealth, 213 Va. 191, 193, 191 S.E.2d 173, 174 (1972).

[13] *Id.* at 196, 191 S.E.2d at 176.

On appeal to the United States Supreme Court,[14] the judgment was vacated and the case remanded for further consideration in light of the Court's decisions in *Roe v. Wade*[15] and *Doe v. Bolton.*[16] The Virginia Supreme Court again affirmed Bigelow's conviction.[17] Appealing a second time to the Supreme Court, the appellant was granted a reversal of his conviction in a 5-2 decision.[18]

Justice Blackmun, writing for the majority, first criticized the Virginia Supreme Court for not examining the appellant's argument that the statute was overbroad.[19] Reaffirming the position taken in *Dombrowski v. Pfister*[20] and other recent cases,[21] he stated that overbreadth is a facial attack upon the statute itself and therefore does not depend upon a showing of a constitutionally privileged activity.[22] However, the Court did not rest its decision on the possible overbreadth of the Virginia statute. Since the stated that overbreadth is a facial attack upon the statute itself in a manner which would effectively repeal its prior application, the question of overbreadth was in essence moot.[23]

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[14]Bigelow v. Virginia, 413 U.S. 909 (1973).

[15]410 U.S. 113 (1973).

[16]410 U.S. 179 (1973).

[17]Bigelow v. Commonwealth, 214 Va. 341, 200 S.E.2d 680 (1973). In a per curiam opinion, the Virginia court stated that the *Roe* and *Doe* decisions were not in conflict with its holding in the *Bigelow* case on the ground that *Roe* and *Doe* dealt strictly with abortion while *Bigelow* involved the question of whether the first amendment permits commercial advertising on the part of a commercial abortion agency.

[18]Justice Blackmun delivered the opinion of the Court, in which Chief Justice Burger and Justices Douglas, Brennan, Stewart, Marshall, and Powell joined. Justice Rehnquist, joined by Justice White, filed a dissenting opinion.

[19]95 S. Ct. at 2230.

[20]380 U.S. 479, 486 (1965).

[21]*See* Grayned v. City of Rockford, 408 U.S. 104, 114 (1972); Gooding v. Wilson, 405 U.S. 518, 520-21 (1972); Coates v. City of Cincinnati, 402 U.S. 611, 616 (1971); NAACP v. Button, 371 U.S. 415, 432 (1963); Thornhill v. Alabama, 310 U.S. 88, 97-98 (1940); Owens v. Commonwealth, 211 Va. 633, 638-39, 179 S.E.2d 477, 481 (1971).

[22]The only limitation the Court placed on this general statement that overbreadth is a sufficient ground to afford standing was the exception ennunciated in Laird v. Tatum, 408 U.S. 1 (1972). The *Laird* Court stated that in order to obtain standing there must be a "claim of specific present objective harm or a threat of specific future harm." *Id.* at 13-14.

[23]The amended statute reads:

> [I]f any person by publication, lecture, advertisement, or by the sale or circulation of any publication, or through the use of a referral agency for profit, or in any other manner, encourage or promote the processing of an abortion or miscarriage to be performed in this State which is prohibited under this article, he shall be guilty of a misdemeanor.

VA. CODE ANN. § 18.1-63 (Cum. Supp. 1974). It is interesting to note that

Proceeding to the central issue of the case, whether this advertisement was within the scope of the first amendment, the Court held invalid the Virginia Supreme Court's assumption that first amendment guarantees of free speech and press are per se inapplicable to paid commercial advertisements.[24] Using the reasoning expressed in *Pittsburgh Press Co. v. Pittsburgh Commission on Human Relations*[25] and *New York Times Co. v. Sullivan*,[26] the Court claimed that merely because an item appeared in the form of an advertisement or had commercial interests did not negate all first amendment guarantees.[27] The test to be employed to determine whether an item is covered by the first amendment is that from *Valentine v. Chrestensen*.[28] Does the advertisement contain "factual material of clear 'public interest.' "[29] In the *Chrestensen* case, the owner of a United States Navy submarine prepared and printed a handbill advertising the boat and soliciting visitors for a stated admission fee. On the opposite side of the handbill was a protest message against action by the City Dock Department in refusing the respondent wharfage facilities at a city pier. New York City had a municipal ordinance which forbade distribution in the streets of commercial and business advertising matter.[30] In deciding this case, the Court found that the protest message was attached to the handbill advertising the exhibition of the submarine solely for the purpose of evading the ordinance. As such it failed to be within the realm of a protected right under the first amendment.

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the Court did not rest its opinion on overbreadth because the amendment rendered the issue moot. Yet, the first amendment issue, upon which the Court did rest its conclusion, would also have been moot in light of the same amendment.

[24] 95 S. Ct. at 2230-31.

[25] 413 U.S. 376, 384 (1973).

[26] 376 U.S. 254, 266 (1964).

[27] 95 S. Ct. at 2231.

[28] 316 U.S. 52 (1942).

[29] 95 S. Ct. at 2232.

[30]

> [N]o person shall throw, cast or distribute, or cause or permit to be thrown, cast or distributed, any handbill, circular, card, booklet, placard or other advertising matter whatsoever in or upon any street or public place, or in a front yard or court yard, or on any stoop, or in the vestibule or any hall of any building, or in a letterbox therein; provided that nothing herein contained shall be deemed to prohibit or otherwise regulate the delivery of any such matter by the United States postal service, or prohibit the distribution of sample copies of newspapers regularly sold by the copy or by annual subscription. This section is not intended to prevent the lawful distribution of anything other than commercial and business advertising matter.

NEW YORK CITY, N.Y., SANITARY CODE § 318.

The *Chrestensen* case was distinguished in *New York Times Co. v. Sullivan*,[31] a case in which an elected official in Montgomery, Alabama claimed that an advertisement appearing in the newspaper libeled him. In examining this case, the Supreme Court noted that the advertisement was not "commercial" in the sense in which the word was used in *Chrestensen*. The distinguishing factor was that the advertisement in the *New York Times* case "communicated information, expressed opinion, recited grievances, protested claimed abuses and sought financial support on behalf of a movement whose existence and objectives are matters of the highest public interest and concern."[32]

Applying these standards to the present case, the Court claimed that the Women's Pavilion advertisement "did more than simply propose a commercial transaction."[33] The Court noted that the advertisement conveyed information of interest not only to readers in need of the services offered, but also to those interested in the law of another state, and those with a general curiosity about abortion reform in Virginia.[34] The fact that the advertisement stated that abortions were now legal in New York, and that there was no residency requirement for obtaining one, supported the Court's view.

The last aspect of the Court's examination of the scope of first amendment protection dealt with whether the State had an interest in its regulation of advertising. The majority concluded that Virginia could in no way supervise the internal affairs of New York.[35] Although Virginia could, through regulations, promote the dissemination of information which enables its citizens to make better informed decisions when they travel to another state, it could not, "under the guise of exercising internal police powers, bar a citizen of another state from disseminating information about an activity that is legal in that [other] State."[36] Finding no legitimate state interest for Virginia to prohibit this particular advertisement, the decision rested with the appellant.[37]

Justice Rehnquist, joined by Justice White, dissented from the opinion of the majority. Their major objections were the Court's finding of "public interest" from a mere two-line blurb and the majority's failure to note Virginia's state interest. The dissenters supported their view that the advertisement was strictly

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[31]376 U.S. 254 (1964).

[32]*Id.* at 266.

[33]95 S. Ct. at 2232.

[34]*Id.* at 2233.

[35]The Court noted the case of Huntington v. Attrill, 146 U.S. 657, 669 (1892), in support of this premise.

[36]95 S. Ct. at 2234.

[37]*Id.* at 2236.

"commercial" by noting that other groups provided the same service as Women's Pavilion without charging a referral fee.[38] Further, they found a legitimate state interest in the fact that this advertisement dealt with the health field.[39] It is considered within the power of a state to "maintain high ethical standards in the medical profession and to protect the public from unscrupulous practices."[40] Thus, finding a reasonable regulation which served a legitimate public interest, Justices Rehnquist and White opposed the holding of the court.[41]

The effect of this case[42] is to limit the "doctrine of commercialism."[43] By stating that any advertisement which contains "factual material of clear 'public interest' "[44] will be deemed protected

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[38]New York has since prohibited the use of referral fees:

> [N]o person, firm, partnership, association or corporation, or agent or employee thereof, shall engage in for profit any business or service which in whole or in part includes the referral or recommendation of persons to a physican, hospital, health related facility, or dispensary for any form of medical care or treatment of any ailment or physical condition. The imposition of a fee or charge for any such referral or recommendation shall create a presumption that the business or service is engaged in for profit.

N.Y. PUB. HEALTH LAW § 4501.1 (McKinney 1971). Virginia adopted a similar statute. VA. CODE ANN. § 18.1-417.2 (Cum. Supp. 1974).

[39]*See, e.g.*, North Dakota Pharmacy Bd. v. Snyder's Stores, 414 U.S. 156 (1973); Williamson v. Lee Optical Co., 348 U.S. 483, 490-91 (1955); Semler v. Dental Examiners, 294 U.S. 608, 612 (1935).

[40]95 S. Ct. at 2238.

[41]*Id.* at 2239-40. The majority opinion rejected this health protection argument because the State's attorneys made no claim that this particular advertisement in any way affected the quality of medical services within Virginia.

[42]Of course, one obvious interpretation of this case in its narrowest form is that the decision was merely the reversal of one man's conviction. Since the statute is no longer in effect and the Court failed to apply the 1972 amendment to this case, one could claim that no grounding for a precedent was set. A rationale for taking this position is seen in the majority's statement that Virginia could not apply the statute "as it read in 1971" to appellant's publication of the advertisement in question without unconstitutionally infringing upon his first amendment rights. The fact that the Court limited its decision to the prior statute and failed to discuss the effect of the amendment might lead to the conclusion that the Court only intended to reverse one man's conviction.

[43]

> [C]ommercial advertising might be distinguished from political and social advocacy because the advertiser's motive or purpose appears to be economic gain, or because the advertisement seeks to influence private decisions among economic alternatives.

78 HARV. L. REV. 1191, 1192 (1965). *See also* 51 N.C.L. REV. 581 (1973); 40 U. CIN. L. REV. 870 (1971); 24 VAND. L. REV. 1273 (1971).

[44]95 S. Ct. at 2232.

by the first amendment, the court enlarged the scope of protected rights. Prior to this case, the court had recognized the right of a state to regulate the business of commercial solicitation and advertising within its borders.[45] Further, the courts had drawn arbitrary distinctions on the basis of the use of the advertising form to grant or not grant first amendment protection. Ideas in books and speeches received constitutional favor, while the same idea conveyed in the form of a commercial advertisement did not.[46] The *Bigelow* decision now eliminates the classification of material by the courts on the basis of the form in which it appears. Advertisements are not per se commercial. When there is an element of public interest, then the advertisement is removed from the commercial realm and offered the protection guaranteed under the first amendment.

A further and more liberal interpretation of this case is that it implies that any advertisement could obtain first amendment protection by including a statement which would be of public interest. It can be claimed that to circumvent the limitation of "commercialism," one need only attach a statement of genuine public interest to the advertisement. One can perhaps ask if the Court in future cases will go so far as to permit an advertiser of an automobile to print items prohibited by state statute where the automobile dealer places in his advertisement statements concerning pollution and emission standards. Further, will newspapers be permitted to include prostitution advertisements and drug sales on the basis that these are areas of social relevance to the general public? The opinion of the Court stresses the desire to keep public control separate from the newspaper. Quoting Chafee, the Court states that "liberty of the press is in peril as soon as the government tries to compel what is to go into a newspaper."[47] The Court concluded with statements to the effect that censorship of the press or governmental action limiting free discussion should be kept to a minimum and only in those situations when it is absolutely essential should there be restrictions placed on the press.[48] The tendency of the court to use words which favor a non-restrictive policy by the government in what can and cannot be printed

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[45]*See, e.g.*, Head v. New Mexico Bd., 374 U.S. 424 (1963); Breard v. Alexandria, 341 U.S. 622 (1951); Packer Corp. v. Utah, 285 U.S. 105 (1932).

[46]Redish, *The First Amendment in the Marketplace: Commercial Speech and the Values of Free Expression*, 39 GEO. WASH. L. REV. 429, 472 (1971).

[47]2 Z. CHAFEE, JR., GOVERNMENT AND MASS COMMUNICTIONS 1633 (1937), *quoted in* 95 S. Ct. at 2236.

[48]95 S. Ct. at 2236.

leads one to the conclusion that advertisements pertaining to prostitution and drugs might pass muster under the Court's standard.

Whatever view one takes as to the effect of this case, it is essential to note that the Court has taken a new position in defining "commercialism." The term no longer includes any advertisement but rather refers only to items which do not contain factual material of a "public interest." The Supreme Court in the *Bigelow* case has made a significant step in the direction of restoring the guarantees of "freedom of speech and press."

ELLEN S. PODGOR